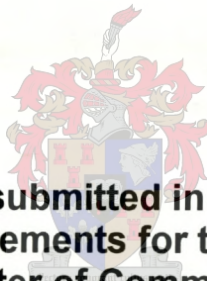


OFFSHORE INVESTMENTS FROM A SOUTH AFRICAN RESIDENT'S PERSPECTIVE

by

DAVID RONALD GRANT



**An assignment submitted in partial fulfilment
of the requirements for the degree of
Master of Commerce
at the University of Stellenbosch**

Supervisor: Professor J.U. de Villiers

January 2003

DECLARATION

I the undersigned hereby declare that the work contained in this assignment is my own original work and I have not previously in its entirety or in part submitted it to any university for a degree.

D.R. GRANT

ABSTRACT

The offshore investment industry has shown tremendous growth (R92,7 billion invested in offshore unit trusts and mutual funds) since the Minister of Finance took the bold step (1 July 1997) availing South African (SA) residents the opportunity to invest offshore. Currently, SA residents, subject to certain criteria, are allowed to invest R750 000 offshore. The primary objective of this assignment is to provide a general overview of offshore investments from a SA resident's perspective. Foreign investment policies as they relate to local residents are reviewed. Investment maxims, truisms and theory are introduced to provide a theoretical framework to accommodate future chapters. The question regarding why South Africans should invest offshore is answered by firstly identifying specific risks that are unique to this country, its people and businesses and, secondly, by looking at market risk. Conclusive empirical evidence states that offshore diversification reduces portfolio risks and enhances returns. Offshore investments, their related costs/fees, investment strategies as well as regulations that offshore investors must adhere to, are also discussed. The most important obstacles to investing offshore, namely the home bias phenomenon and currency or exchange rate risk, are placed in perspective. Important tax implications for investing offshore are also briefly mentioned. In the final chapter conclusions and recommendations are made.

OPSOMMING

Die buitelandse beleggingsindustrie het merkwaardig gegroei (R92,7 biljoen is tans in buitelandse effekte-truists en onderlinge fondse belê) sedert die Minister van Finansies die dapper stap geneem het (1 Julie 1997) om Suid-Afrikaanse (SA) burgers die geleentheid te bied om in die buiteland te kan belê. Huidiglik kan SA burgers, onderworpe aan sekere kriteria, tot R750 000 in die buiteland belê. Die primêre doelwit van hierdie werkstuk is om 'n oorsig vanuit die SA burger se perspektief voor te lê. Buitelandse beleggingsbeleide, asook hoe hulle SA burgers beïnvloed is in oënskyn geneem. Beleggingsgrondstellings, -waarhede en -teorieë, is bespreek om 'n teoretiese agtergrond te verskaf vir latere hoofstukke. Die vraag waarom Suid-Afrikaners in die buiteland moet belê, word beantwoord deur eerstens, spesifieke risiko's wat uniek is aan ons land, sy mense en besighede, te identifiseer, en tweedens, om na markrisiko's te kyk. Konklusiewe empiriese navorsing bewys dat buitelandse beleggings die risiko's van portefeuljes verlaag en opbrengste verhoog. Buitelandse beleggings, hul verwante koste/fooi, beleggingstrategieë, asook regulasies waaraan buitelandse beleggings moet voldoen, is bespreek. Die belangrikste struikelblokke vir belegging in die buiteland, bekend as die sogenaamde "home bias"-verskynsel en valuta- of wisselkoersrisiko's, is in perspektief gestel. Belangrike belastingsimplikasies vir buitelandse beleggings word ook kortliks genoem. In die finale hoofstuk word gevolgtrekkings en aanbevelings gemaak.

ACKNOWLEDGEMENTS

I am grateful to the following people for their guidance, advice, patience, professional assistance, unwavering support and care over the years:

- Professor J.U. de Villiers;
- Mrs L. Moser and Ms J.F. Clack;
- My parents, wife and children.

I thank them as I do every one who has in any way helped me in writing this assignment.

CONTENTS

	Page
Declaration	(i)
Abstract	(ii)
Opsomming	(iii)
Acknowledgements	(iv)
Contents	(v-x)
List of Illustrations	(xi)
List of Tables	(xii-xiii)

CHAPTER 1

1. INTRODUCTION	1
1.1 BACKGROUND	1
1.2 WHY THIS TOPIC?	1
1.3 OUTLINE OF ASSIGNMENT	2

CHAPTER 2

2. OBJECTIVES, METHODOLOGY AND LIMITATIONS OF THE ASSIGNMENT	5
2.1 INTRODUCTION	5
2.2 OBJECTIVES	5
2.3 KEY CONCEPTS DEFINED	5
2.4 METHODOLOGY	6
2.4.1 Literature review of existing research, publications and text books	6
2.4.2 Personal visits and interviews with offshore fund managers and providers	6
2.4.3 Personal experience	6
2.5 LIMITATIONS OF THE ASSIGNMENT	7
2.5.1 Research availability	7
2.5.2 Sensitive and confidential information	7
2.5.3 Limited use	7
2.5.4 Logistic limitations	8
2.6 SUMMARY	8

	Page
CHAPTER 3	
3. SOUTH AFRICAN FOREIGN INVESTMENT POLICIES AS THEY RELATE TO RESIDENTS	9
3.1 INTRODUCTION	9
3.2 FOREIGN EXCHANGE RATE POLICY AND POLICY WEAKNESSES PRIOR TO 1997	11
3.3 RECOMMENDATIONS RELATING TO EXCHANGE CONTROL POLICY AS PER THE DE KOCK COMMISSION'S FINAL REPORT	14
3.4 CURRENT EXCHANGE CONTROL REGULATIONS	16
3.5 RELAXATION OF FOREIGN EXCHANGE POLICY	17
3.6 EXCHANGE CONTROL SHOULD BE ABOLISHED	21
3.7 SUMMARY	21
CHAPTER 4	
4. INVESTMENT MAXIMS, TRUISMS AND THEORY	23
4.1 INTRODUCTION	23
4.2 INVESTMENT	23
4.3 GENERAL REMARKS, MAXIMS AND TRUISMS REGARDING INVESTING	24
4.4 THE INVESTMENT PROCESS	26
4.5 IMPORTANT FACTORS AFFECTING THE INVESTOR AND INVESTMENTS	27
4.5.1 Risk	27
4.5.2 Liquidity	28
4.5.3 Taxation	29
4.5.4 Inflation	29
4.6 PORTFOLIO RETURNS	29
4.7 PORTFOLIO RISK	30
4.8 TOTAL RISK	32
4.9 THE CAPITAL ASSET PRICING MODEL: LINKING RISK AND RETURNS	33
4.10 BETA AS A MEASURE OF RISK	36
4.11 THE SECURITY MARKET LINE	37
4.12 USING THE CAPITAL ASSET PRICING MODEL (CAPM)	38
4.13 CAPITAL MARKET EFFICIENCY	40
4.14 ARBITRAGE PRICING THEORY (APT)	43
4.15 SUMMARY	44

	Page
CHAPTER 5	
5. WHY INVEST OFFSHORE?	45
5.1 INTRODUCTION	45
5.2 DIVERSIFICATION	46
5.2.1 Diversifiable (specific or unsystematic) risk and international diversification	49
5.2.1.1 Lack of international competitiveness	50
5.2.1.2 Corruption, crime and corporate governance	54
5.2.1.3 Productivity and skills shortage	55
5.2.1.4 AIDS/HIV virus	57
5.2.1.5 Country or political risk	60
5.2.1.6 Economic growth	61
5.2.1.7 Exchange rates and exchange rate risk	66
5.2.1.8 Empirical evidence	72
5.2.2 Non-diversifiable (market or systematic) risk and international diversification	74
5.2.2.1 Beta and correlation coefficient	75
5.2.2.2 International empirical evidence	76
5.2.2.3 South African empirical evidence	78
5.3 SOUTH AFRICA'S RELATIVE SIZE AS A MATURE EMERGING MARKET	83
5.4 PERFORMANCE AND RISK	86
5.4.1 Domestic savings	86
5.4.2 Historical rates of return	87
5.4.2.1 South African historical rates of return	88
5.4.2.2 Global historical rates of return	92
5.4.2.3 Lessons from the past	99
5.5 GEOGRAPHICAL SEGMENTATION	101
5.6 SUMMARY	102

	Page
CHAPTER 6	
6. AN OVERVIEW OF OFFSHORE INVESTMENTS	103
6.1 INTRODUCTION	103
6.2 OFFSHORE PRODUCTS IN GENERAL	103
6.2.1 Distinction between rand-denominated foreign investments and foreign-based offshore investments	104
6.3 RAND-DENOMINATED OR LOCALLY DOMICILED FOREIGN INVESTMENTS	106
6.3.1 Rand hedge equities	107
6.3.2 Assurance funds	109
6.3.3 Unit trusts	113
6.3.4 Tranches	116
6.3.5 Costs and transparency	117
6.3.6 Advantages and disadvantages	118
6.4 FOREIGN-BASED OFFSHORE INVESTMENTS	119
6.4.1 Financial Services Board approved investments	120
6.4.2 Equities and bonds	120
6.4.3 Assurance funds	123
6.4.4 Mutual funds	124
6.4.5 Standard and Poor's Depository Receipts, American Depository Receipts and World Equity Benchmark Shares	126
6.4.6 Property	128
6.4.7 Tank containers	128
6.4.8 Foreign currency bank accounts	129
6.4.9 Hedge funds	130
6.4.10 Options and warrants	131
6.4.11 Costs and cumulative break-even returns	132
6.4.12 Advantages and disadvantages	133
6.5 INTERNATIONAL INVESTMENT STRATEGIES AND INVESTMENT MANAGERS	134
6.5.1 International investment strategies	134
6.5.2 Portfolio management styles	135
6.5.2.1 Passive equity style investing	136
6.5.2.2 Active equity style investing	138
6.5.2.3 Passive and active bond style investing	142

	Page
6.5.3 Investment managers	143
6.5.3.1 Single fund managers	144
6.5.3.2 Fund of fund managers	144
6.5.3.3 Multi-managers	145
6.6 REGULATIONS APPLICABLE TO PRIVATE INDIVIDUALS INVESTING OFFSHORE	146
6.7 SUMMARY	148

CHAPTER 7

7. OBSTACLES TO INVESTING OFFSHORE	149
7.1 INTRODUCTION	149
7.2 HOME BIAS	149
7.3 OVER-EMPHASISING PERFORMANCE	157
7.4 VAST ARRAY OF CHOICES	157
7.5 JURISDICTION AND CURRENCY SELECTION	158
7.6 COSTS	158
7.7 SUMMARY	158

CHAPTER 8

8. TAX IMPLICATIONS OF OFFSHORE INVESTMENTS	159
8.1 INTRODUCTION	159
8.2 INCOME TAX	159
8.2.1 Taxation of residents on their worldwide income	159
8.2.2 Rand-denominated products	163
8.2.3 Foreign-based offshore investments	164
8.2.4 Capital Gains Tax	166
8.3 ESTATE DUTY	167
8.4 SUMMARY	168

	Page
CHAPTER 9	
9. CONCLUSIONS AND RECOMMENDATIONS	169
9.1 INTRODUCTION	169
9.2 CONCLUSIONS	169
9.3 RECOMMENDATIONS	172
 REFERENCES	 176

LIST OF ILLUSTRATIONS

	Page
Figure 4.1 The CAPM can be illustrated graphically as follows	35
Figure 4.2 The security market line (SML)	38

LIST OF TABLES

		Page
Table 5.1	World Competitiveness Scoreboard (Selected Countries, 1996-2000)	52
Table 5.2	Real growth in GDP and income levels 1991-1999	63
Table 5.3	Population size 1991-2000	63
Table 5.4	Growth records for a number of widely differing economies between 1997 and 2000	65
Table 5.5	The value of the Rand in American cents from 1970 to 1999	68
Table 5.6	Various organisations' forecasts of Rand USD exchange rates	69
Table 5.7	Risk, return and correlations of international shares and bonds in Rands, 1990 to 2000	79
Table 5.8	Portfolios	82
Table 5.9	Classification of world markets	83
Table 5.10	Data on market capitalisation, GNP, %GDP, number of listed Corporations and GNP/capita	85
Table 5.11	South African five-year rolling periods (with pre-tax income reinvested)	89
Table 5.12	Average annual combined returns (local currencies, 1990-1999)	93
Table 5.13	Real (after inflation) average annual combined returns (local currencies, 1990-1999)	94
Table 5.14	Extracts from basic and derived series: Historical highlights (1926-1998)	95

			Page
Table	5.15	Risk and return for US dollar investors from international stock (shares), bonds and cash, 1971-1998	96
Table	5.16	Various countries' equity index converted back to rands for the period 1990-1999	97
Table	5.17	Equity and bond returns over the 10-year period (including income rollup) in US dollars converting to income rands	98
Table	5.18	Risk premium calculated for investing in equities over a 27-year period (1971-1998)	99
Table	6.1	Sliding scale of brokerage charges	107
Table	6.2	Cost of purchasing shares	108
Table	6.3	Charges against policyholders	112
Table	6.4	Initial charges and funds available for investment <i>after</i> charges and compulsory cash holdings	115
Table	6.5	Costs of two popular tranche products	117
Table	6.6	Cumulative break-even returns for the various rand-denominated investments discussed	118
Table	6.7	Costs of foreign broker-assisted equity trading	121
Table	6.8	Costs of purchasing a foreign fixed interest instrument	122
Table	6.9	Break-even returns for various foreign-based offshore investments	132
Table	7.1	Pension fund holdings of securities issued by non-residents in September 1998	151
Table	7.2	Foreign assets (South Africa's investment in other countries), 1986-1998	152

CHAPTER 1

CHAPTER 1: INTRODUCTION

	Page
1.1 BACKGROUND	1
1.2 WHY THIS TOPIC?	1
1.3 OUTLINE OF ASSIGNMENT	2

Chapter 1

INTRODUCTION

1.1 BACKGROUND

Prior to 1 July 1997 exchange control regulations forbade South Africa's residents from investing offshore. Residents could only gain access to foreign income by investing in rand hedge shares and/or tank containers.

On the aforementioned date the Minister of Finance eased foreign exchange restrictions by placing a ceiling of R200 000 on the amount that SA residents were allowed to invest offshore. Subsequent relaxations increased this amount. At present, SA residents are allowed to invest R750 000 offshore during their lifetime.

South Africans living in a commodity-based emerging market in desperate need of economic growth and foreign direct investment, contending with a volatile currency and living on a politically unstable continent, were now afforded the opportunity to diversify their portfolios offshore.

1.2 WHY THIS TOPIC?

The importance and relevance of this topic can be substantiated by considering the following facts:

- As previously stated, R750 000, subject to certain criteria, may be invested anywhere in the world. Empirical research clearly indicates that offshore diversification reduces portfolio risk and enhances returns.
- At the end of June 2002 (approximately five years after the initial easing of foreign exchange regulations), the value of investments in both rand-denominated and foreign-based offshore unit trusts amounted to R92,7 billion.

This figure represents $\pm 38\%$ of the R244 billion total of assets under management in the South African unit trust industry.

- Slow economic growth, rand depreciation and the amount of funds transferred offshore may have combined to place a, hopefully temporary, halt on the Government's declared policy of a gradual continual easing of foreign exchange controls. Many argue that punitive tax legislation (unlike local dividends, foreign dividends are taxed, etc.) and the imposition of the 10% of net inflow of funds rule, for authorised dealers (see Chapter 3), are methods used by the authorities to disincentivise offshore investments.

The main, practical reasons that influenced me to decide on this particular topic are as follows:

- The importance and relevance thereof, as already discussed in the preceding paragraphs.
- The assistance, guidance and availability of a supervisor who publishes regularly on investment related topics and theory.
- The availability of empirical research published in academic journals and other literature that deals extensively with the many benefits of offshore diversification.
- Enhanced knowledge and the practical assistance one is able to offer existing and potential clients regarding the many benefits that can be derived from investing offshore.

1.3 OUTLINE OF ASSIGNMENT

The following topics are discussed in this assignment:

Chapter 2 briefly mentions and discusses the objectives, defines certain terms, methodology used and the limitations of this assignment.

Chapter 3 discusses South African foreign investment policies as they relate to residents. The major recommendations and contribution of the De Kock Commission's final report on past and present exchange control regulations are mentioned. Current exchange control regulations, relaxation of foreign exchange policy and why same should be abolished are also discussed.

Chapter 4 commences with general remarks, maxims and truisms regarding the investor and investments. Thereafter, important concepts that include portfolio and total risk are discussed. A theoretical framework, to accommodate the interpretation and understanding of future chapters, is introduced by briefly making relevant observations regarding the Capital Asset Pricing Model (CAPM), the Efficient Market Hypothesis (EMH) and the Arbitrage Pricing Theory (APT).

Chapter 5 discusses why South African residents should invest offshore. Diversifiable (specific or unsystematic risk) and non-diversifiable (market or systematic) risk are discussed. Specific problems relating to the South African market and investments are highlighted. Empirical evidence that indicates the advantages of international diversification is quoted and discussed. Non-diversifiable (market or systematic) risk, international and South African empirical evidence are examined.

Other reasons why investing offshore is prudent, including South Africa's relative size as a mature, emerging market, reduction in portfolio risk, as well as enhanced returns and geographical segmentation, are deliberated in this chapter. The results of empirical research quoted in this chapter provide compelling reasons for South African residents to diversify their portfolios offshore.

Chapter 6 identifies and discusses the various rand-denominated and foreign-based offshore investments available. Costs and/or fees are identified and the implications thereof on investment returns are highlighted. International investment strategies, investment managers and the regulations that SA residents need to adhere to are also mentioned.

Chapter 7 discusses obstacles to investing offshore. The phenomenon called home bias is discussed. The risk associated with currency or exchange rate risk as well as over-emphasis on performance is identified. Other obstacles briefly mentioned include the variety of products and fund managers, jurisdiction and currency selection as well as costs.

Chapter 8 briefly discusses residency-based income tax and the principle that all foreign income should be declared on tax returns.

Chapter 9 concludes the assignment. Conclusions and recommendations are made.

CHAPTER 2

CHAPTER 2: OBJECTIVES, METHODOLOGY AND LIMITATIONS OF THE ASSIGNMENT

	Page
2.1 INTRODUCTION	5
2.2 OBJECTIVES	5
2.3 KEY CONCEPTS DEFINED	5
2.4 METHODOLOGY	6
2.4.1 Literature review of existing research, publications and text books	6
2.4.2 Personal visits and interviews with offshore fund managers and providers	6
2.4.3 Personal experience	6
2.5 LIMITATIONS OF THE ASSIGNMENT	7
2.5.1 Research availability	7
2.5.2 Sensitive and confidential information	7
2.5.3 Limited use	7
2.5.4 Logistic limitations	8
2.6 SUMMARY	8

Chapter 2

OBJECTIVES, METHODOLOGY AND LIMITATIONS OF THE ASSIGNMENT

2.1 INTRODUCTION

To ensure that the end result coincides with the stated objectives, it is important to refer to the procedures and methodology used in the compilation of this assignment.

2.2 OBJECTIVES

The primary objective of this assignment is to provide a general overview of offshore investments from a South African resident's perspective. This general view encompasses the following secondary objectives:

- South African foreign investment policies as they relate to residents;
- Investment maxims, truisms and theory as they relate to offshore investments;
- Why South African residents should invest offshore;
- An overview of offshore investments available;
- Obstacles to investing offshore;
- Important income tax implications of investing offshore.

2.3 KEY CONCEPTS DEFINED

For the purpose of this assignment, South African residents only include natural persons. Legal persons, for instance Companies and Close Corporations, are excluded.

Offshore investments, for South African residents wanting to invest offshore, fall into two different categories, namely:

- Rand-denominated foreign investments (previously known as asset swap investments). These are locally domiciled investments or funds; and
- Foreign-based (or foreign currency) offshore funds. These are externally domiciled investments or funds.

2.4 METHODOLOGY

This assignment has been completed in accordance with generally accepted principles of academic and scientific objectivity. The following activities took place:

2.4.1 Literature review of existing research, publications and text books

There is a fair amount of research and publications available regarding the secondary objectives, as mentioned in section 2.2. As evident from the quoted references, quite a lot of local and international research, publications and text books have been used. Newsletters, business newspapers as well as regularly published financial magazines were also consulted.

2.4.2 Personal visits and interviews with offshore fund managers and providers

Various visits and interviews were conducted with local and offshore product providers and brokerage houses. Quarterly and annual presentations, as presented by the major fund managers doing business in South Africa, as well as regular investment related seminars, presented by the Financial Planning Institute of South Africa, were attended.

2.4.3 Personal experience

The author has been involved and familiar with marketing of offshore products since July 1997. Regular meetings and seminars with fund managers, product providers and financial intermediaries who market offshore products are attended.

2.5 LIMITATIONS OF THE ASSIGNMENT

The following restrictions and limitations were encountered during the compilation of this assignment:

2.5.1 Research availability

Although there is a fair amount of research available, the research specifically dealing with the benefits of offshore diversification mostly refer to the period prior to May 1994. The effects of the newly elected government plus rand volatility are thus not reflected in the aforementioned research.

Obtaining information regarding specific and exact costs and/or fees relating to the various offshore investments mentioned, was arduous.

The local home bias phenomenon and currency or exchange rate risk appear not to be well researched in RSA.

2.5.2 Sensitive and confidential information

Some of the offshore product providers were rather secretive and not transparent regarding total costs. They seem to indicate that in some instances costs would be determined subject to the specific rand amount invested, the amount of business provided to them by the particular financial intermediary, as well as the negotiating skills of the investor.

2.5.3 Limited use

Although vast amounts of rands (R92,7 billion invested in offshore unit costs) are invested offshore, a very small portion of the South African population enjoy the benefits of diversification that offshore investing provides. Reasons for the aforementioned include low disposal incomes, relatively high monthly premiums and/or high initial capital required to access offshore investments.

2.5.4 Logistic limitations

Due to time and cost constraints it was obviously impossible to communicate with all the product providers, especially those offshore non-approved Financial Services Board providers.

2.6 SUMMARY

The secondary objectives developed as a result of the pursuance to provide a perspective on offshore investments for the South African investor (primary objective).

A perusal of the references indicate that extensive use was made of empirical studies (from primary and secondary sources) as well as other publications, text books, seminars and personal interviews, to enable the achievement of the primary objective.

CHAPTER 3

**CHAPTER 3: SOUTH AFRICAN FOREIGN INVESTMENT POLICIES AS THEY
RELATE TO RESIDENTS**

	Page
3.1 INTRODUCTION	9
3.2 FOREIGN EXCHANGE RATE POLICY AND POLICY WEAKNESSES PRIOR TO 1997	11
3.3 RECOMMENDATIONS RELATING TO EXCHANGE CONTROL POLICY AS PER THE DE KOCK COMMISSION'S FINAL REPORT	14
3.4 CURRENT EXCHANGE CONTROL REGULATIONS	16
3.5 RELAXATION OF FOREIGN EXCHANGE POLICY	17
3.6 EXCHANGE CONTROL SHOULD BE ABOLISHED	21
3.7 SUMMARY	21

Chapter 3

SOUTH AFRICAN FOREIGN INVESTMENT POLICIES AS THEY RELATE TO RESIDENTS

3.1 INTRODUCTION

Exchange control was first introduced in South Africa in 1939, at the outbreak of the Second World War, in the form of the Emergency Finance Regulations (Kruger, De Kock and Roper, 2001:97). The current control measures were introduced via the Exchange Control Regulations of 1961, which were promulgated in Government Notices R1111 and R1112 of 1 December 1961, issued in terms of the Currency and Exchange Act 9 of 1933.

South Africans were thus not allowed to invest capital in offshore markets for many years. Their only access to foreign currency income was obtained via rand hedge shares (South African listed shares that earned foreign currency from exports or offshore companies they owned) and tank containers (tank containers are rented to companies needing to transport goods). Capital was, however, illegally transferred out of South Africa.

In June 1995, South African institutional investors (long term insurers, pension funds and unit trusts companies) were given permission to exchange part of their South African portfolio for foreign securities through approved asset swap transactions. (Asset swaps are explained later in this chapter.) Subsequently, limited asset swap transactions were allowed from which resident investors could benefit. The first asset swap transactions took place in 1995 via Sanlam's Offshore Fund (Swart, 1999:100). Single premium endowment policies (with a minimum single premium of R250 000) were made available to the public. These endowments exposed investors to market and exchange rate risks. Sanlam limited this offer to 500 endowment policies.

As previously stated, prior to 1 July 1997 South African residents could only earn foreign currency income via rand hedge shares and/or tank container investments. Limited opportunities to invest via institutional investors making use of asset swaps became available in December 1995.

In July 1997 the Minister of Finance eased foreign exchange restrictions on offshore investments and placed a ceiling of R200 000 on foreign investments by South African residents. Residents could now, subject to certain conditions that will be discussed later, directly invest offshore without making use of the rather expensive asset swap mechanism offered by institutions.

Subsequent relaxations increased the ceiling to R400 000 (in March 1998), then to R500 000 (in March 1999) and then to R750 000 (in February 2000).

Prior to July 1997, permission was granted, at the Reserve Bank's discretion, only to South African companies when making direct offshore investments. Permission was only granted if the South African companies met certain criteria. One of the important criteria was that the South African company should obtain control over the foreign company.

During 1977 the South African government appointed a Commission of Inquiry (later to become known as the De Kock Commission) to enquire into the functioning of the monetary systems and monetary policy in South Africa. This commission issued interim reports and, among other findings, also identified major problems relating to the South African foreign exchange market.

The remainder of this chapter provides an overview of foreign exchange rate policy, policy weaknesses prior to 1997 and the recommendations of the final De Kock Commission's report. It then describes foreign exchange policy and briefly discusses the current policy. The chapter finally comments on the possible abolishment of exchange control in the future.

3.2 FOREIGN EXCHANGE RATE POLICY AND POLICY WEAKNESSES PRIOR TO 1997

The foreign exchange rate policy per Government Notices R1111 and R1112 of 1 December 1961, as amended, precluded South African residents from investing offshore. As previously stated, only corporates, with the required Reserve Bank approval, were allowed to invest offshore.

The De Kock Commission's (1978) investigation identified several deficiencies in the foreign exchange policy in South Africa. Three major deficiencies, which had major and serious implications for South African companies and individuals wanting to invest offshore, were identified as follows:

- The absence of an active and competitive foreign exchange market in RSA. The Reserve Bank determined the rand-dollar exchange rate and also prescribed the buying and selling rates at which banking institutions had to deal with their clients. The foreign exchange market in South Africa was thus subject to a form of price control by the Reserve Bank. A major defect of the fixed rand-dollar pegged exchange rate system was that changes in South Africa's balance of payments position was immediately reflected in the level of foreign reserves held by the Reserve Bank, and not in the official exchange rate.
- The purchase of foreign investments requires the purchase of foreign currency. In the 'spot' market, foreign exchange transactions are traded currently or on the 'spot'. The De Kock Commission (1978:15) also stated that the deficiency in the spot foreign exchange market, arising from very high spreads between buying and selling rates charged by authorised currency dealers in RSA, was a major problem. The relatively wide and fixed spreads made foreign exchange markets in South Africa inefficient. The wide margins had the effect of diverting exchange dealings, involving large transactions, to overseas exchange markets where narrower margins were available.

- Serious weakness in the forward exchange market. The purchase of forward cover was only available for transactions involving goods and related services. Forward cover was unavailable to the private sector for transactions such as loan repayments, interest, royalties, dividends and capital invested in foreign securities.

Prindle (as cited in Bhana, 1985) showed that most operators in international financial markets used foreign exchange hedging as a means of reducing the risk arising from currency fluctuations. As portfolio managers were precluded from obtaining forward cover on the repatriation of their foreign investments, this increased the risk of investing in foreign securities.

Currency control measures were introduced in June 1961. These measures were introduced to prevent significant capital outflow, which became severe after political unrest, and especially after the Sharpeville incident. The proceeds from the sales of assets belonging to non-resident South Africans were blocked (prevented from leaving South Africa) and such assets became known as blocked rands. A non-resident could thus only repatriate funds by selling his particular assets to another non-resident. No nett outflow of capital thus resulted. Later (February 1976) this mechanism was extended. Now non-residents were allowed to transfer blocked rand balances between each other and the range of assets they were allowed to invest in was extended to include certain shares and government bonds (gilts). The aforementioned resulted in developing a market in blocked rand balances and such a fund became known as a securities rand ('effekterand').

With the implementation of the De Kock report (January 1979), the term 'securities rand' was substituted with the term 'financial rand'. One of the De Kock Commission's long term recommendations was that a single exchange rate system be implemented. In other words, the abolishment of the financial rand and exchange control over non-residents.

On 7 February 1983, Horwood (1983a) announced that the South African Reserve Bank had abolished exchange control over non-residents. However, in September 1985 the financial rand mechanism was reimplemented due to substantial capital flight (among others, as a result of political unrest and an unfavourable response from foreign countries to the now infamous 'Rubicon speech' by then President P.W. Botha in August 1985). South Africa finally abolished the dual currency system on 13 March 1995. The demise of the financial rand meant that non-residents were now allowed to freely transfer or use the proceeds from the sale of their South Africa-owned assets.

The aforementioned announcement was important because it resulted in partially freeing financial markets, although it still left a major part of exchange control intact. Exchange control over South African residents was retained.

During August 1983 Horwood (1983b) stated that it was their intention to improve the technical functioning of the foreign exchange market. This was, as the De Kock reports clearly alluded to, a prelude to further relaxation of exchange control.

Horwood (1983b) also announced that the forward exchange cover provided by the Reserve Bank to authorised exchange dealers would be phased out over a three-year period. Secondly, any banking institution that sold forward cover to its clients would be required to buy the required currency in the spot market. It was further announced that, as from 5 September 1983, the Reserve Bank would pay South African gold mines in dollars instead of in rands, as in the past. Like any other exporter, the mines would be required to sell their dollar earnings to authorised foreign exchange dealers.

From the aforementioned it can be observed that the monetary authorities commenced attempting to create a more market-related foreign exchange market in South Africa.

Semadeni (as cited in Bhana, 1985) also identified the following major shortcomings of the local foreign exchange market, which had a major influence on the technical functioning thereof:

- the local exchange market is very small in terms of international standards;
- the rand is traded on a limited basis internationally;
- the local foreign exchange market operated during South African office hours only. With the major differences in time zones, this added to liquidity problems.

Goedhuys (as cited in Bhana, 1985) identified the following shortcomings of the local foreign exchange market:

- the Reserve Bank only deals with authorised dealers and all dealings are done in dollars only. The dealers are thus required to approach overseas markets to convert dollars into other foreign currencies.
- the great distance of South Africa from all other major foreign exchanges results in local dealers facing high operating costs on relatively small turnovers. Because of the aforementioned, the spread between buying and selling rates for non-dollars is much higher than that for United States dollars.

South African operators in the foreign exchange market are thus paying much higher transaction costs than those in developed countries.

3.3 RECOMMENDATIONS RELATING TO EXCHANGE CONTROL POLICY AS PER THE DE KOCK COMMISSION'S FINAL REPORT

The primary reason for the existence of exchange control was to minimise the drain on the country's foreign reserves.

During 1985, the De Kock Commission released the final report of its study of the monetary system and monetary policy in South Africa. The most important findings and recommendations will be briefly mentioned because the monetary and fiscal policies of subsequent governors of the Reserve Bank and Ministers of Finance have partially implemented the findings and recommendations of the

De Kock Commission. The most relevant and important findings and recommendations were:

- To establish a market-related monetary policy in South Africa.
- The exchange control over South African residents should be relaxed and simplified. The complete abolishment of exchange control was not recommended.

The De Kock Commission (1985:133) gave the following motivation for further relaxation of exchange control in South Africa: "In reaching this decision the Commission took special cognisance of the political uncertainties in South Africa. It was also influenced by the realisation that it will still take some time for an active, competitive and generally efficient forward exchange market to develop in South Africa. In these circumstances it was judged that the complete abolition of all remaining exchange control at this stage might produce unacceptable, even though temporary, disruption in the form of some combination of undue downward pressure on the reserves and/or the exchange rate, undue upward pressure on interest rates, and declines in share prices and real estate values."

- That existing liberal application of exchange control relaxation in respect of direct investment by resident South African companies in foreign companies be further relaxed so that such acquisitions become automatic, provided they meet the established criteria (1985:134). This recommendation encouraged listed companies like Barlow Rand Ltd, Anglo American Corporation Ltd, and Liberty Life Ltd, to become involved in the purchase and takeovers of foreign companies (1985:134).
- A progressive relaxation of exchange control over foreign portfolio investments. The De Kock Commission (1985:134) recommended that initially registered insurers, pension funds and mutual funds (unit trust companies) be allowed to invest 10% of their annual cash inflows in securities approved by the Registrar of Financial Institutions. The Commission also recommended that in the future such permission should be extended to financial institutions and mining houses. The Commission also recommended that eventually permission should be granted to individuals and non-corporate bodies to invest offshore.

The aforementioned could be accomplished, for instance, by allowing each individual to make foreign investments up to certain predetermined amounts. The De Kock Commission did not specify any time period, but suggested that the state of both the balance of payments and the domestic economy should be conducive to implement these relaxations.

The De Kock Commission's (1985) recommendations relating to the relaxation of exchange control for South African residents recognised that the existing measures were inefficient in rationing available foreign exchange among various domestic users. Market forces would allocate foreign exchange more efficiently.

The De Kock Commission (1985) did not completely abolish exchange control, though it provided the basic guidelines, which would ultimately lead to a system where foreign exchange allocation would entirely be left to market forces.

The bulk of these recommendations was implemented and now forms part of current foreign rules and regulations.

3.4 CURRENT EXCHANGE CONTROL REGULATIONS

The South African Reserve Bank regulates exchange control through banks that are authorised foreign exchange dealers. The regulations contain only prohibitive and compulsive clauses. They are there to monitor and protect the country's foreign currency reserves. Currency reserves largely consist of gold bullion, currency balances and amounts owed to South African banks by banks abroad. People affected by these regulations are:

- residents of South Africa;
- non-residents of South Africa;
- emigrants; and
- immigrants.

According to Goodall (2001:Part 2, section 6.4), the prohibitive and compulsive clauses could be summarised as follows:

No person other than an authorised dealer may buy or sell foreign currency without the consent of the South African Reserve Bank. No person may export currency, gold or securities without the approval of the South African Reserve Bank.

No person may grant any financial assistance to any person who is not a resident in South Africa or to any non-South African company. This is subject to the South African Reserve Bank's permission.

Every person who becomes entitled to sell or procure the sale of any foreign currency shall sell it to an authorised dealer within seven days.

Private individuals who earn foreign currency in any form are exempt from the regulation. Without the approval of the South African Reserve Bank, no person may:

- acquire or dispose of, in any way, any security acquired from a non-resident;
- act as a nominee for a non-resident;
- make any entry in a security register to transfer a security into or out of the name of a non-resident;
- change the address of a non-resident in a security register unless that change is within the same monetary area;
- make any entry in the security register that shows a local address of a non-resident purchaser; and
- no person shall deal in any bearer securities or options without the consent of the South African Reserve Bank.

3.5 RELAXATION OF FOREIGN EXCHANGE POLICY

In June 1995 the government introduced the concept of asset swaps as a further relaxation of exchange control (Goodall, 2001:Part 2, section 6.1). According to Kruger, De Kock and Roper (2001:98), "an asset swap is an exchange of investment assets between two parties in different countries. It is important to

note that the asset swap transaction will not impact negatively on the exchange rate as no capital outflows actually take place.”

Asset swaps thus allowed South Africans to enjoy some of the benefits of offshore investment, while ensuring that there was no drain on the country's foreign exchange reserves.

This was the only way in which South Africans could invest offshore prior to the measures that allowed for direct offshore investment by individuals, apart from investing in tank containers and rand hedge shares.

South African institutions such as long term insurers, pension funds, fund managers and unit trusts were permitted to swap a percentage of total assets under management. Currently the percentages permitted are 15% of total assets for long term insurers, pension funds and fund managers, and 20% for unit trusts (Hartmann, Veldtman, Hoffmann, Stofberg, Schoeman, Dawson, 2001:B50).

During the budget speech of 21 February 2001, the Minister of Finance acknowledged that the asset swap mechanism had served a useful purpose, facilitating a fairly rapid portfolio diversification.

According to Kruger et al. (2001;98), South African institutions invested over R100 billion abroad since the inception of asset swaps in 1995.

During the budget speech in 1997, the Minister of Finance announced that, as from 1 July 1997, South African citizens (natural persons), subject to certain criteria, would be allowed to invest R200 000 offshore (and/or hold foreign currency at local banks). These ‘certain criteria’ will be discussed. Further relaxations of the exchange rate policy were announced during the 1998 budget speech when the ceiling was increased from R200 000 to R400 000. This limit was increased to R500 000 (1999 budget) and subsequently to R750 000 on 23 February 2000 with immediate effect.

The certain criteria referred to above are as follows:

- an individual must prove to the authorised dealer that he or she is 18 years or older;
- the potential offshore investor should also be in possession of a declaration of good standing issued by South African Revenue Services. South African Revenue Services will only issue such a certificate once all outstanding and due taxes have been paid and all the applicant's taxes are up to date; and
- that the applicant has not exceeded the prescribed limit (R750 000) allowed.

In the 2001 budget, changes were made with regard to how institutions could invest offshore. The South African Reserve Bank issued Exchange Control Circular number D.320, which states the following:

"In terms of existing limits, long term insurers and pension funds may acquire foreign portfolio investment by way of asset swaps for up to 15% of their total assets and fund managers up to 15% of their total assets under management. Unit trusts through unit trust management companies may acquire foreign portfolio investments for up to 20% of their total assets under management. Whilst these limits are retained, it has been decided to terminate the use of the asset swap mechanism by institutional investors, with immediate effect. Institutional investors will, however, still be allowed to acquire foreign portfolio investments up to the defined foreign portfolio limits by way of foreign currency transfers based on a percentage of the previous year's inflow of funds.

Authorised dealers are, accordingly, advised that long term insurers, pension funds and unit trusts through unit trust management companies may now apply to the Control to avail of foreign currency transfers in 2001 of up to 10% of the nett inflow of funds during the 2000 calendar year to acquire portfolio investments in SADC and elsewhere, subject to the existing limits in place."

According to Goodall (2001:Part 2, section 6.4), "the current limits of the foreign asset holdings of institutional assets are retained, e.g. 15% of the total assets for

long term insurers, pension funds and fund managers, and 20% of total assets for unit trusts. However, the mechanism whereby institutions invested overseas, namely asset swaps, has been terminated. Now institutions can invest up to the aforementioned defined foreign asset limits through cash transfers based on a prescribed percentage of the previous year's nett inflow of funds. At present this is 10%."

According to Kruger, De Kock and Roper (2001:164) the scrapping of the asset swap mechanism means that the holder of South African assets (South African institutions) no longer needs to find an offshore asset swap partner.

The aforementioned limitation unfortunately meant that many rand-denominated unit trust and insurance funds were forced to close their doors for new business because they did not adhere to the new '10% of nett inflow of funds' rule.

On maturity or disposal of the asset swap the full proceeds must be paid out in South Africa, in rands.

The aforementioned could be seen as a reimposition of exchange control or, at the least, a tightening of the limits by the South African Reserve Bank.

National treasury director-general Maria Ramos (Katzenellenbogen, 2001(b)) says that the national treasury remained fully committed to the liberalisation of exchange control.

In the same article she goes on to say that the R17,4 billion in outflows under the personal investment allowance (inception date 1 July 1997 until the end of 2000) was "pretty modest" and "not a concern" and that the use of the facility was an acceptable part of portfolio diversification.

The aforementioned termination of asset swaps and the limiting of insurers, pension funds and unit trust management companies to only avail of foreign currency transfers in 2001 of up to 10% of their nett inflow of funds during the

2000 calendar year, have had the effect that many rand-denominated unit trusts are unable to invest offshore. This opportunity for the South African investor to use this very convenient method of investing offshore has thus been limited.

3.6 EXCHANGE CONTROL SHOULD BE ABOLISHED

According to Grant (1992:1) exchange control is one of the many types of government interference that has been used to achieve third world status.

Surely, after an investor has paid tax on his or her earnings, they should be able to invest their after-tax money wherever they can obtain the highest risk adjusted return. If they are able to choose a safer and more productive location for their capital this should be allowed without Reserve Bank intervention. Investors would thus be able to benefit from international diversification of their assets.

Exchange control treats the symptoms and fails. Is it not an investor's constitutional right to invest his or her after-tax savings where he or she wishes?

3.7 SUMMARY

Basically, subject to the already mentioned exceptions, South African residents were, prior to July 1997, precluded from investing offshore. On 1 July 1997 the Minister of Finance announced that South African investors, subject to certain criteria, were allowed to invest R200 000 offshore. Subsequent relaxations have increased this amount to R750 000.

The aforementioned relaxations are as a result of the implementation of the recommendations made in the final De Kock Commission Report (1985). The most important recommendations were:

- to establish a market-related monetary policy in South Africa;
- that exchange control over residents be relaxed and simplified;

- that existing liberal application of exchange control relaxation in respect of direct investment by resident South African companies be further relaxed so that such acquisitions become automatic, provided certain criteria are adhered to;
- a progressive relaxation of exchange control over foreign portfolio.

Regulations regarding exchange control, as well as how the exchange rate policy has been relaxed, were discussed.

Brief comments as to why the abolishment of exchange should take place were also made.

CHAPTER 4

CHAPTER 4: INVESTMENT MAXIMS, TRUISMS AND THEORY

	Page
4.1 INTRODUCTION	23
4.2 INVESTMENT	23
4.3 GENERAL REMARKS, MAXIMS AND TRUISMS REGARDING INVESTING	24
4.4 THE INVESTMENT PROCESS	26
4.5 IMPORTANT FACTORS AFFECTING THE INVESTOR AND INVESTMENTS	27
4.5.1 Risk	27
4.5.2 Liquidity	28
4.5.3 Taxation	29
4.5.4 Inflation	29
4.6 PORTFOLIO RETURNS	29
4.7 PORTFOLIO RISK	30
4.8 TOTAL RISK	32
4.9 THE CAPITAL ASSET PRICING MODEL: LINKING RISK AND RETURNS	33
4.10 BETA AS A MEASURE OF RISK	36
4.11 THE SECURITY MARKET LINE	37
4.12 USING THE CAPITAL ASSET PRICING MODEL (CAPM)	38
4.13 CAPITAL MARKET EFFICIENCY	40
4.14 ARBITRAGE PRICING THEORY (APT)	43
4.15 SUMMARY	44

Chapter 4

INVESTMENT MAXIMS, TRUISMS AND THEORY

4.1 INTRODUCTION

In this chapter investment is defined and general remarks, maxims and truisms regarding investments are made. The investment process and important factors affecting the investor and investments are also mentioned.

Investment theory commences with discussions of portfolio returns (section 4.6). Important concepts that include portfolio risk and total risk are discussed briefly.

A theoretical framework, to accommodate the interpretation and understanding of future chapters, is introduced by briefly making relevant observations regarding the CAPITAL ASSET PRICING MODEL (CAPM), the EFFICIENT MARKET HYPOTHESIS (EMH) and the ARBITRAGE PRICING THEORY (APT).

4.2 INVESTMENT

According to Amling (1984:3), an investment may be defined as the purchase by an individual or institutional investor of a financial or real asset that produces a return proportional to the risk assumed over some future investment period. The purchase of any asset that offers the expectation of income and capital gains may be defined as an investment.

4.3 GENERAL REMARKS, MAXIMS AND TRUISMS REGARDING INVESTING

In the preface of Graham's (1973:vii) classic bestseller on value investing, Warren E. Buffet makes the following comment: "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."

According to Peter Lynch (1989:32), "investing in stocks is an art, not a science, and people who've been trained to rigidly quantify everything have a big disadvantage. Logic is the subject that's helped me the most in picking stocks, if only because it taught me to identify the peculiar logic of Wall Street."

Individuals over the course of a lifetime will rarely have exactly the same amount of income as desired consumption. In some periods, they will have more income than desired consumption, at other times, the opposite will occur. The excess income is saved. How these funds are employed is investment (Reilly and Brown, 1997:1). An individual thus gives up current consumption in order to enjoy a greater amount of consumption in the future (Reilly and Brown, 1997:1).

Because investors look to be compensated for the uncertainty associated with future outcomes or investment risks they usually receive a risk premium.

According to Reilly and Brown (2000:5), "investment is the current commitment of dollars for a period of time in order to derive future payments that will compensate the investor for (1) the time the funds are committed, (2) the expected rate of inflation, and (3) the uncertainty of the future payments." This definition includes all types of investments. Thus shares, bonds, commodities, property, antiques and the rest are included.

The investor is trading a known rand amount today for some expected future stream of income or capital that should be greater than the current outlay. The

risk adverse investors' required rate of return should thus compensate the investor for the uncertainty of the return plus the expected rate of inflation.

Chapter 5 provided reasons why the risk adverse prudent investor should diversify and invest offshore. Historical empirical studies, as discussed in the next chapter, clearly indicated that South African investors could reduce their portfolio risk and enhance investment returns by diversifying their portfolio to include offshore developed markets' securities and assets.

Amling and Droms (1982:322) identify certain financial prerequisites that must be met prior to making investments. According to the aforementioned authors, these financial prerequisites are:

- you should have adequate life insurance;
- you should have equity in a home;
- you should have a modest amount of consumer debt;
- you should have a satisfactory level of money in a current account;
- you should have adequate savings for an emergency; and
- you should have enough money to invest to make it profitable and economical.

Considering the various changes and vicissitudes in life, this is indeed sage advice.

According to Bodie, Kane and Marcus (2001:15): "globalisation is a tendency towards a worldwide investment, and the integration of national capital markets." According to the same source, financial markets are traditionally segmented into money markets and capital markets. Money markets include short term marketable, liquid, low risk securities. Capital markets include longer term and higher risk securities.

If a wider range of investment choices can benefit the South African investors, why should they limit themselves to invest in purely local assets or securities? More efficient communications technology and the dismantling of regulatory constraints have encouraged globalisation. In a global marketplace, investors should have a

global outlook. For example, they need to determine how competitive the local asset or security is (in international terms), how internationally competitive the country in which they are investing is, and so on. A major step towards globalisation took place in 1999 when 11 European countries established a new currency called the euro. One of the main ideas behind the euro is that a common currency will facilitate global trade and encourage the integration of markets across national boundaries. Are President Mbeki's talks and ideas regarding the African Renaissance not the initiation of something similar for the African continent?

4.4 THE INVESTMENT PROCESS

An investor's portfolio is simply an investor's collection of investment assets. Investment assets are usually categorised into broad asset classes such as shares, bonds or gilts, property, commodities, and so on.

On constructing a portfolio investors usually make two decisions, namely:

- asset allocation; and/or
- security selection.

Asset allocation decisions are the choice among broad asset classes, while the security selection decision is the choice of which particular security to hold within each asset class (Bodie, Kane and Marcus, 2001:8). According to the aforementioned source, 'top down' portfolio construction commences with asset allocation. The potential investor would then first decide on what proportion of the total portfolio will be held in shares, bonds and properties, and so on. Only after the asset allocation decision has been made will the investor make decisions regarding the specific securities (e.g. Anglo American PLC or Iscor Ltd) that should be purchased for the portfolio.

In contrast, security selection and analysis involves the valuation of a particular share or bond that might be included in the portfolio. For instance, a bond (e.g. RSA 150) or a particular share would be evaluated for inclusion in the portfolio.

The security offering the best value and/or growth potential would then usually be included in the portfolio. This is called the 'bottom up' strategy. Warren Buffet, Prudential and Allan Gray are examples of individuals and asset management companies that use the 'bottom up' strategy. A 'bottom up' strategy does focus the portfolio on the security that seems to offer the most attractive investment opportunities (best value).

4.5 IMPORTANT FACTORS AFFECTING THE INVESTOR AND INVESTMENTS

According to Hartmann, Veldtman, Hoffmann, Stofberg, Schoeman and Dawson (2001:B1), important factors affecting investors' investment strategies are:

- risk;
- liquidity;
- taxation; and
- inflation.

Each of the aforementioned, as it relates to offshore investments, will be discussed briefly.

4.5.1 Risk

Three aspects regarding risk need to be considered. The first is the risk inherent in the specific asset class (for example, shares or bonds). Secondly, the risk that the investor is prepared to accept, and thirdly, the expected term of the investment (term to maturity).

- **Risk inherent in the specific asset class**

The well-known investment maxim stating the higher the potential income or expected growth, the higher the risk, is applicable. Thus various investment asset classes carry varying risks. Money market instruments carry far less risk than capital market instruments. Various securities, in capital markets, also carry varying degrees of risk. Considering the information provided in Table 5.15 it can be observed that the standard deviation for stocks (shares) is

greater than for cash and bonds. The investor should thus understand the risk inherent in the asset class and the security they choose to invest in.

- **The investor**

The amount of risk investors can afford or are prepared to accept will also vary. The potential investor should try to determine his or her risk tolerance or risk profile. According to Hartmann et al. (2001:B2), "some of the factors that should be considered in determining risk tolerance are:

- Generally, the older the person the more risk adverse they are.
- Generally, the longer the term the higher the potential risk that can be absorbed.
- Generally, the larger the disposable income the higher the risk that could potentially be absorbed.
- The client's investment experience. Will the client understand the implications of high-risk investment or equities?
- The client's knowledge of investments."

- **Term of the investment**

As previously stated, the longer the investment term, the higher the potential risk that can be absorbed.

Chapter 5 discusses the virtues of reducing risk and enhancing returns via offshore diversification. The relative risk associated with investing in equities (local or offshore) is higher than investing in bonds. Investors should understand this risk before investing locally or offshore.

4.5.2 Liquidity

Potential investors need to ensure that they have enough cash on hand to meet emergency expenses (e.g. medical costs, etc.) as well as planned and possible unplanned future expenses. Amling and Droms' (1982:322) financial prerequisites, as discussed in section 4.3, need to be heeded.

Many investors incur big losses due to the fact that they are required to liquidate their investments, or part of their investments, in times of market turmoil.

4.5.3 Taxation

Investments yielding the highest yield are not necessarily always the 'best' investments. After-tax returns are of importance. It is important that investors are informed on how various offshore investments are taxed. Chapter 8 will briefly discuss the tax implications of investing offshore.

4.5.4 Inflation

Inflation is responsible for the decline in the purchasing power of money. According to Hartmann et al. (2001:B8), "the rule of 72 is used to determine how long it will take for the purchasing power of money to halve at a given inflation rate. Example: $72 \div \text{present inflation rate}$. Assuming an inflation rate of 8% per annum indicates that in 9 years ($72 \div 8\%$) the purchasing power of money will halve."

The need to maintain, and preferably increase, the real value of an investment in inflationary times has to be a primary objective of investment planning. The after-tax and after-inflation returns on low risk money market instruments (e.g. savings accounts) are usually subject to a steady loss in real value. Investors who wish to protect the purchasing power of their money are compelled to invest in investments that have the possibility of growth. Investments that should provide growth inherently carry a greater degree of risk.

4.6 PORTFOLIO RETURNS

Harry Markowitz published a 15-page paper entitled 'Portfolio Selection' in the March 1952 issue of the *Journal of Finance*. In this paper, Markowitz looked at how one could put together a collection of assets in order to create an efficient portfolio. According to Bodie, Kane and Marcus (1999:933) and Gitman

(1985:G12), an efficient portfolio is a portfolio that provides a maximum return for a given level of risk or a minimum risk for a given level of return.

According to Marx, De Swart and Nortjé (1999:54), the expected return of a portfolio (R_p), is simply the average of the returns for the securities weighed by the proportion of the portfolio devoted to each security. Mathematically it can be stated as follows:

$$R_p = W_A r_A + W_B r_B + \dots W_Z r_Z$$

where

- R_p = the expected rate of return on a portfolio.
- $W_A \dots W_Z$ = the proportion of the portfolio devoted to security A through security Z (the sum of $W = 1$ or 100%).
- $r_A \dots r_Z$ = the expected rates of return on securities A through Z.

Stated differently, it could be said that the expected return of a portfolio is the weighted average of the expected return of the securities in the portfolio. Each security in the portfolio will have a different risk profile. The securities in the portfolio will not necessarily move together in the same direction.

4.7 PORTFOLIO RISK

A portfolio's risk is measured by its standard deviation. Unlike the expected return on a portfolio, the portfolio risk is not a weighted average of the standard deviations of the securities making up the portfolio. To understand why, one must consider the concept of correlation. Correlation measures the degree with which two variables, such as the returns on two securities, move together. Correlation takes on a numerical value between +1,0 to -1,0. The sign (either a + or a -) indicates whether the returns move together positively (+) or inversely (-). If the correlation is negative (-), the securities move inversely; that is, when the return for one share decreases, the return of the other increases. The riskiness of a portfolio, Markowitz argued, has to be separated from the riskiness of the separate investments (or securities) that make up the portfolio. What is important is how the various investments relate to each other. This is known as their covariance.

The risk of a large portfolio is the average covariance of the pairs of securities in the portfolio.

Marx et al. (1999:56) summarise these important facts as follows:

- “If the securities are perfectly positively (+) correlated, there is no reduction in risk from forming a portfolio.
- When the correlation between the security returns is less than +1,0, there are benefits from diversifying in terms of risk reduction. The only exception to this is when all portfolio funds are invested in one asset.
- The maximum risk reduction is achieved when the returns on two securities move exactly opposite to each other so that their correlation is -1,0 (or they are perfectly negatively correlated). It is this negative correlation that one should try to maximise, through diversification, when investing part of a portfolio offshore.
- Returns on most securities are positively (but not perfectly positively) correlated. This occurs because the returns on most assets tend to move, to a greater or lesser degree, with the general movements in the economy.”

The aforementioned have hopefully illustrated the fact that portfolio risk can be reduced by forming portfolios. The risk reduction is optimised when securities in the portfolio are negatively correlated.

According to Bodie, Kane and Marcus (1999:203), the portfolio standard deviation falls (reduces) as the number of securities increases, but it cannot be reduced to zero. The risk that remains even after extensive diversification is called market risk; risk that is attributed to market wide risk sources. Specific or unsystematic risk as well as market or systematic risk are discussed in Chapter 5.

An analysis of an empirical study done by Stratman (as cited in Bodie et al., 1999:202) shows the effect of portfolio diversification using data on the New York Stock Exchange (NYSE) stocks. This empirical study reveals that an average portfolio risk does fall (reduce) with diversification, but the power of diversification to reduce risk is limited by systematic (market) risk or common sources of risk.

According to the study, the benefits of diversification are maximised after attaining a number of ± 20 securities in the portfolio.

4.8 TOTAL RISK

According to Marx et al. (1999:56), total risk can be divided into two parts: diversifiable risk (sometimes called company specific or unsystematic risk), and non-diversifiable risk (sometimes called market or systematic risk). Stated differently: total risk = diversifiable risk + non-diversifiable risk.

Ellis (as cited in Rosenberg, 1991) identifies three types of risk; one that can not be avoided and two that can be eliminated through careful portfolio management.

The risk types identified by Ellis are as follows:

- Diversifiable risk (unsystematic risk). This risk comprises two different risks, both of which can be avoided by diversification. The first is a specific risk, which is the risk that a specific security will behave differently from the overall market. The second is extra market risk, which is the risk that a group of securities will behave differently from the overall market. The diversifiable risk (specific risk and the extra-market risk) can be avoided by diversification and creating portfolios that replicate the market.

Gitman (1985:242) says the following about diversifiable risk: "... it results from the occurrence of uncontrollable or random events such as strikes, lawsuits, regulatory actions, loss of a key account and so forth." Because unsystematic risk can be eliminated at virtually no cost (by diversifying), there is no reward for bearing it.

- Market (or systematic) risk is inherent to the market as a whole and cannot be avoided. However, it can be increased by gearing or reduced by spreading a portfolio over several markets. Market or systematic risks are thus unanticipated events that affect all assets to the same degree because the effects are economy wide. This risk cannot be avoided by diversification. Factors such as war, inflation, international incidents and political events (e.g. present situation in Zimbabwe) would account for non-diversifiable risk. This

risk is usually assessed in relation to the risk of a diversified portfolio of assets, which is commonly called the market portfolio or the 'market'.

4.9 THE CAPITAL ASSET PRICING MODEL: LINKING RISK AND RETURNS

In 1963, William Sharpe developed a simpler version of the Markowitz model (Goodall, 2001:Part 2, section 1.4). The two ideas of risk reduction via diversification and risk premiums associated with more risky investments led to the development of the capital asset pricing model (CAPM). Sharpe suggested that instead of calculating the covariances between each set of securities (in the portfolio), one only calculate the relationship between each security and the dominant factor. This dominant factor is the market portfolio.

There are certain underlying assumptions in the CAPM as a model of market equilibrium (Draper and Findlay, 1982:161) which include:

- All assets are tradeable (and therefore are traded) and are divisible.
- Investors are risk-averse and possess risk-averse preferences, which are summarised only by the mean and variance of returns.
- Markets are frictionless with all information available at all times to all participants.
- Investors have homogenous beliefs about the return distribution (assumed jointly normal).
- A risk-free asset exists and investors may either borrow or lend at the risk-free rate.

Even though the aforementioned assumptions may appear to be limiting, all of these can be relaxed without seriously affecting the basic conclusions derived from the model (Marx et al., 1999:57).

Sharpe, very importantly, introduced the ability of investors to borrow or lend at the risk-free rate. This means that investors cannot only invest in a portfolio of risky securities but also in a risk-free security (e.g. treasury bills). If, for example, an

investor wants to take on more risk, money can be borrowed at the risk-free rate and the borrowings invested in the market portfolio. If the investor wants to reduce the portfolio risk money can be loaned by investing in the risk-free asset and investing the rest in the efficient portfolio.

As previously stated, an efficient portfolio is one where it is not possible to construct another portfolio with the same return but lower risk, or the same risk but higher return. According to Reilly and Brown (2000:325), "The market portfolio includes all the risky assets in the economy. Further, in equilibrium, the various assets would be included in the portfolio in proportion to their market value. Therefore, this market portfolio should contain not only US stocks and bonds, but also real estate, options, art, stamps, coins, foreign stocks and bonds, and so on, with the weights equal to their relative market value."

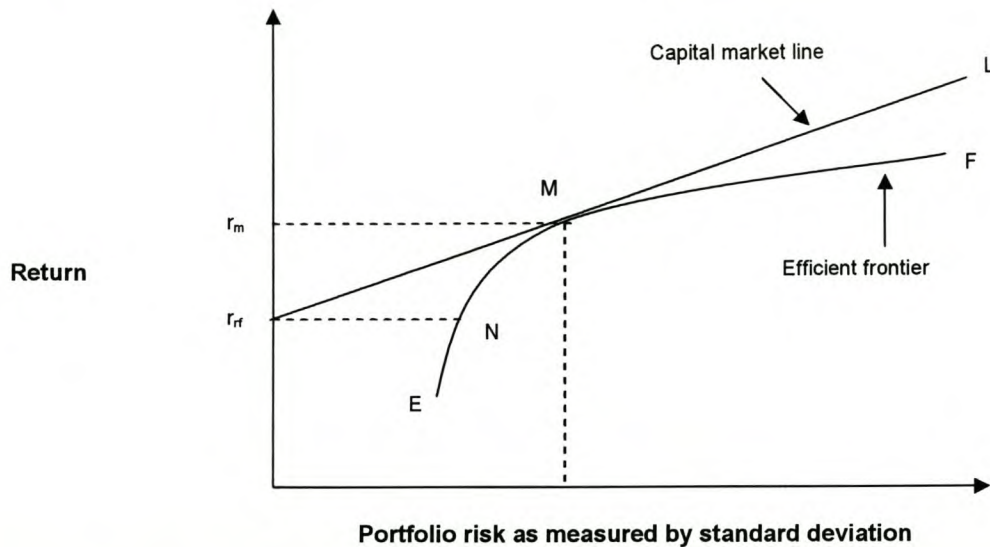
This concept of the market portfolio is thus reasonable in theory, but difficult if not impossible to implement when using the CAPM. Because of the difficulty in obtaining timeous relevant information on the various assets already mentioned, most studies limit themselves to using either a share or bond index. Most studies choose the S&P 500 or some other American index as the market portfolio. According to Reilly and Brown (2000:325) this is clearly incorrect as it constitutes less than 20% of a truly global risk asset portfolio.

It was thus assumed that the indices used, as a proxy for the market portfolio, were highly correlated with the true market portfolio. According to Reilly and Brown (2000:325) several articles by Roll concluded that using the aforementioned indices as a proxy for the market portfolio had serious implications for tests of the model and especially for using the model when evaluating portfolio performances. At present there is a big debate as to whether the market portfolio is efficient.

CAPM assumes that investors will not hold different portfolios, but different amounts of the market portfolio. Thus all investors will hold the market portfolio. Each investor will adjust their particular risk/return profile by combining the market portfolio with different amounts of money invested at the risk-free rate.

The CAPM can be illustrated graphically as follows:

Figure 4.1



r_m = Return on the market portfolio.

r_{rf} = Return on risk-free security (e.g. treasury bill).

Source: Reilly, F.K. and Brown, K.C. 1997. *Investment Analysis and Portfolio Management*. Dryden, Orlando, Florida.

According to Marx et al. (1999:57), “Investors can now combine this riskless security (r_{Rf} e.g. treasury bill) with portfolios on the efficient frontier of risky portfolios to obtain combinations of risk return payoffs that did not exist before. The specific portfolio selected on the efficient frontier is portfolio M (the market portfolio); it is the only portfolio on the efficient frontier that is tangent to a straight line starting at r_{rf} . The new set of risk-return opportunities is given by the line $r_{rf}ML$. All portfolios on the line segment between r_{rf} and M represent lending portfolios, because when an investor buys a treasury bill, he is lending to the government at the risk-free rate. Investors are also assumed to be able to borrow at the risk-free rate. Consequently, any investor who is willing to accept higher risk (than M) to obtain higher returns (than r_m) may borrow at r_{rf} and invest the borrowings plus their initial funds in the risky portfolio, M. These borrowing portfolios are represented by the line segments that extend from M to L.”

From the aforementioned it should be clear that all investors are better off holding portfolios that are linear combinations of the risk-free security (either lending or borrowing) and one risky portfolio, M (the market portfolio). As previously stated, the market portfolio is a value-weighted portfolio of all risky securities. It must contain all risky securities in proportion to their market value to the total value of the portfolio. Such a market portfolio is, however, not observable. In practice, a broad-based share index is often used as a proxy for the market portfolio.

According to Figure 4.1, the line $r_{rf}ML$, the efficient frontier, is called the capital market line (CML). The CML has an intercept of r_{rf} , which is the return on the risk-free security. For an investor to invest in the market portfolio he/she should receive a return of r_m . Thus the investor is compensated for carrying the risk of investing in a market portfolio by receiving a return of $r_m - r_{rf}$ (the risk premium). The slope of the CML is called the market price of risk and can be thought of as the equilibrium expected reward per unit of risk. The CML thus shows the trade-off between risk and return for efficient portfolios.

Because all efficient portfolios must lie on the CML, the required return on an efficient portfolio in equilibrium is equal to the risk-free rate plus the market price of risk multiplied by the amount of risk on the portfolio being considered (Marx et al., 1999:59).

4.10 BETA AS A MEASURE OF RISK

For securities held in a diversified portfolio, the contribution of any one security to the riskiness of a particular portfolio is its market (non-diversifiable) risk. For securities in a diversified portfolio, risk can best be measured by how their returns are correlated to the returns of the portfolio as a whole. For diversified investors the appropriate measure of risk is how the return on an individual share (security) performs relative to the return for the market portfolio. Market risk is measured by beta (β_j), where the subscript j refers to the j 'th security. The beta reflects the

market risk remaining for, say security j , after a portion of its total risk has been diversified away by forming a portfolio.

According to Marx et al. (1999:59) the beta coefficient, β , is the measure of the asset's volatility in relation to the riskiness of the market portfolio as a whole. In other words, it measures what the returns on the asset are expected to be, relative to the returns on the market.

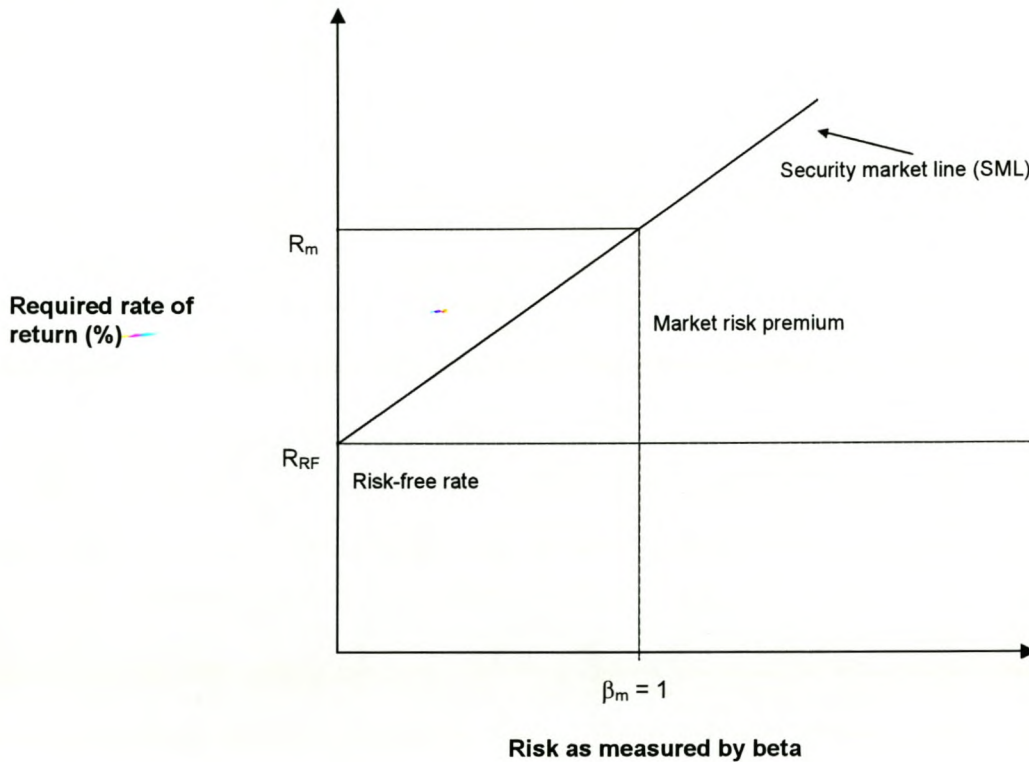
If one uses the share market as a whole as a frame of reference, it has a beta of 1,0. As previously stated, the beta for an individual share indicates the expected volatility of that share in relation to the volatility of the market portfolio.

Any share whose return fluctuates over time exactly as the market does, is an average-risk share and also has a beta of 1,0. Risky shares, whose returns tend to fluctuate faster than the general market's return, are more volatile and will have betas greater than 1,0.

4.11 THE SECURITY MARKET LINE

According to Figure 4.1 the capital market line represents the risk-return trade-off for efficient portfolios. The total risk of a portfolio is represented by the standard deviation of the portfolio returns. The best measure for a particular security risk is the beta.

The risk-return relationship for an individual security can now be formulated. To obtain the risk-return relationship for an individual security, Figure 4.1 can be reformulated. The line shown in Figure 4.2 is called the security market line (SML) and identifies the risk-return trade-off for an individual security or asset.

Figure 4.2

Source: Marx et al. (1999:62).

Figure 4.2 shows that if an investor wants a higher return, he must incur more risk. The security market line thus shows that the required rate of return of any share is equal to the return of a security that has no risk (R_{RF}) plus a risk premium ($R_M - R_{RF}$).

4.12 USING THE CAPITAL ASSET PRICING MODEL (CAPM)

To employ the CAPM to estimate required rates of return, it is necessary to determine three variables, namely:

- Risk-free rate of return (r_{rf}).

Typically the rate of return obtained from treasury bills (Marx et al., 1999:63) and/or long term government bonds (gilts) are used.

- Expected return on the market portfolio (r_m).

According to Marx et al. (1999:63), "The expected return on the market can be estimated by relying on econometric forecasts, or by viewing the expected return on the market as a function of three items: (i) expected inflation, (ii) real growth in the economy, and (iii) a risk premium commanded by shares over debentures. An alternative would be to use the historical or expected market-risk premium, which is simply the difference between the returns on the market portfolio and the risk-free rate."

This could then be added to the risk-free rate, as estimated by treasury bills or long term government bonds, obtaining an estimate of the expected return on the market.

- Beta (β).

Betas of various securities are published by various advisory services.

There is concern that an incorrect market proxy will affect the beta risk measures as well as the position and slope of the security market line (SML). According to Reilly and Brown (2000:329), "In general, the errors will tend to overestimate the performance of portfolio managers because the proxy used for the market portfolio is probably not as efficient as the true market portfolio, so the slope of the SML will be underestimated."

The aforementioned benchmark problems, however, do not invalidate the value of the CAPM. The CAPM is currently a comprehensive model to depict the relationship between risk and return.

According to Bodie, Kane and Marcus (1999:262) the CAPM can be reduced to the following five ideas:

- Investors can eliminate some risk – such as the risk that workers will strike, or that a firm's boss will quit – by diversifying across many regions and sectors.
- Some risks, such as global recession, cannot be eliminated through diversification. So even a basket of all the stocks in a stock market will still be risky.

- People must be rewarded for investing in such a risky basket by earning returns above those that they can get on safer assets, such as treasury bills.
- The reward on a specific investment depends only on the extent to which it affects the market basket's risk.
- Conveniently, that contribution to the market's risk can be captured by a single measure – dubbed 'beta' – which expresses the relationship between the investment's risk and the market's risk.

Although the CAPM describes the major factors (risk versus return) that investors consider when making financial decisions, caution needs to be used when using the model. A suitable restraint is:

Markowitz's first observation was that the portfolios should be thought of in terms of risk and return, not on an ex-post basis, but rather in an ex-ante basis. In other words, the theory has to do with forward-looking risk and forward-looking returns.

To use historical data without adjustments for future expectations invites trouble. Future risk and returns – not past – are the items of concern.

4.13 CAPITAL MARKET EFFICIENCY

An important function of markets is to transmit information about products and prices, so the participants can make rational, informed buy-and-sell decisions. A market is regarded as efficient if prices reflect all available relevant information and adjust quickly to any new relevant information (Eiteman and Stonehill, 1986:428). The concept of market efficiency has been encapsulated in the so-called 'Efficient Market Hypothesis' of which there are three forms (Ross, Westerfield, Jordan, Firer, 1999:293).

- **Weak:** The first form of efficiency asserts that security prices already reflect all information that can be desired by examining market information such as the history of past prices and trading volumes. This would imply that technical analysis (trend analysis) is fruitless.

- **Semi-strong:** If a market is semi-strong then all publicly available information is reflected in the share price. This form of efficiency is very controversial because it implies the security analysts who try to identify mispriced shares using, for example, fundamental analysis (analysing a specific company's financial statements) and technical analysis (plotting the price movements of a particular share/security and drawing inferences from price movements) are wasting their time because that information is already reflected in the current price. According to Bodie, Kane and Marcus (1999:362) the American markets are very efficient.

Studies (as cited in Ross et al., 1999:293) on the South African unit trust industry over the period 1977 until 1986, done by Biger and Page (1993), confirmed the earlier findings of Knight and Firer (1989), namely, that on a risk adjusted basis unit trusts did not outperform the market index. This does not imply that unit trusts are bad investments. Although these funds fail to achieve consistently better returns than some market indices, they do allow investors with small (modest) amounts of capital to achieve diversification.

- **Strong:** If the market is strong efficient, then share prices reflect all information relevant to the company, even including information available only to company insiders. According to Bodie, Kane and Marcus (2001:271), "this version of the hypothesis is quite extreme. Few would argue with the proposition that corporate officers have access to pertinent information long enough before public release to enable them to profit from trading on that information."

According to Marx et al. (1999:65), "An efficient market is one where information is widely and cheaply available to all investors, and where all relevant and ascertainable information is already reflected in security prices. The efficient market hypothesis states that prices react quickly and unambiguously to new information. By unambiguously, we mean that the price may sometimes overreact, while at other times it may underreact, but in general, the magnitude of the reaction will be 'on target'."

The efficient market hypothesis (EMH) does not arouse enthusiasm in the professional portfolio management community. It implies that a great deal of the

activity of portfolio managers – the search for undervalued securities – is at best wasted effort, and quite probably harmful to clients because it costs money and leads to imperfectly diversified portfolios (Bodie, Kane and Marcus, 1999:342). Consequently, the EMH has never been widely accepted by professional fund managers, and debate continues today on the degree to which security analysts can improve investment performance.

So, are markets efficient? According to Bodie, Kane and Marcus (2001:274), “There are three factors that together imply the debate probably never will be settled: the magnitude issue, the selection bias issue, and the luck event issue.” These factors will not be discussed. They go on to say that “there are enough anomalies in the empirical evidence to justify the search for underpriced securities that clearly goes on. The bulk of the evidence suggests that any supposedly superior investment strategy should be taken with many grains of salt. The market is competitive enough that only differentially superior information or insight will earn money; the easy pickings have been picked. In the end, it is likely that the margin of superiority that any professional can add is so slight that the statistician will not be able to detect it.” They conclude by saying that, “markets are very efficient, but rewards to the especially diligent, intelligent, or creative may be waiting.”

According to Ross, Westerfield, Jordan and Firer (1999:291), “The EMH asserts that well-organized capital markets such as the New York Stock Exchange, are efficient markets, for all practical purposes. In other words an advocate of the EMH might argue that while inefficiencies may exist, they are relatively small and not common.”

Reilly and Brown (2000:254) have the following to say, “There is some good news and some bad news. The good news is that the practice of investment analysis and portfolio management is not an art that has been lost to the great computer in the sky. The bad news is that many bright, hardworking people with extensive resources make the game tough. In fact, these competitors have created a fairly

efficient capital market in which it is extremely difficult for most analysts and portfolio managers to achieve superior results.”

The investment consultant or potential investor's view on the EMH will obviously greatly impact on the investment policy and/or strategy that will be used. Will their investment policy be based on technical analysis, fundamental analysis or active or passive portfolio management? Investment policy will be discussed in Chapter 6.

According to Marx et al. (1999:66), empirical testing indicates that returns on the market portfolio appears to be the most important variable for the majority of firms. This being the case, the CAPM continues to be a useful model for representing the relationship between risk and required rates of return for large, actively traded countries (e.g. USA), where large companies are actively followed by a large number of analysts. This resulted in the birth and popularity of index funds.

4.14 ARBITRAGE PRICING THEORY (APT)

The CAPM is a single factor model. It specifies that risk is a function of only one factor, namely the relationship between a security's return and the market return (or equivalently, the security's beta coefficient).

An alternative to the CAMP is the Arbitrage Pricing Theory (APT). APT was developed by Stephen Ross, who proposed that the required return could be a function of multiple factors (Ross, 1976:341-360).

According to Rosenberg (1991:25), “The major importance of the APT, however is the absence of very strong assumptions, especially the lack of reliance on a true market portfolio. In short, therefore, the APT and other multi-factor models are a step towards assisting portfolio management in ‘nearly efficient markets’ as are believed to exist in Modern Portfolio Theory.”

4.15 SUMMARY

This chapter has defined investments and modern portfolio theory. It provides a theoretical basis for the next chapters, especially the discussion on offshore diversification.

The Capital Asset Pricing Model, the efficient market hypothesis, as well as the Arbitrage Pricing Theory (APT) have been briefly introduced.

The crux of modern portfolio theory is that through efficient diversification the overall risk of an investment portfolio can be reduced, as combinations of investments with different cyclical characteristics smooth the volatility of returns of the portfolio. The essential concept of portfolio theory is that the risk of a security as a component of a portfolio is very different from its risk in isolation.

CHAPTER 5

CHAPTER 5: WHY INVEST OFFSHORE?

	Page
5.1 INTRODUCTION	45
5.2 DIVERSIFICATION	46
5.2.1 Diversifiable (specific or unsystematic risk) and international diversification	49
5.2.1.1 Lack of international competitiveness	50
5.2.1.2 Corruption, crime and corporate governance	54
5.2.1.3 Productivity and skills shortage	55
5.2.1.4 AIDS/HIV virus	57
5.2.1.5 Country or political risk	60
5.2.1.6 Economic growth	61
5.2.1.7 Exchange rates and exchange rate risk	66
5.2.1.8 Empirical evidence	72
5.2.2 Non-diversifiable (market or systematic) risk and international diversification	74
5.2.2.1 Beta and correlation coefficient	75
5.2.2.2 International empirical evidence	76
5.2.2.3 South African empirical evidence	78
5.3 SOUTH AFRICA'S RELATIVE SIZE AS A MATURE EMERGING MARKET	83
5.4 PERFORMANCE AND RISK	86
5.4.1 Domestic savings	86
5.4.2 Historical rates of return	87
5.4.2.1 South African historical rates of return	88
5.4.2.2 Global historical rates of return	92
5.4.2.3 Lessons from the past	99
5.5 GEOGRAPHICAL SEGMENTATION	101
5.6 SUMMARY	102

Chapter 5

WHY INVEST OFFSHORE?

5.1 INTRODUCTION

In July 1997 the Minister of Finance eased foreign exchange restrictions on offshore investments. This and subsequent relaxations have allowed South African residents, subject to certain rules, to invest R750 000 offshore.

Modern investment theory suggests that investors earn a return for foregoing the use of their capital plus a premium for bearing risk.

Considering the aforementioned, this chapter distinguishes between diversifiable and non-diversifiable risk. Thereafter, both the aforementioned are discussed.

Reasons are provided and discussed as to why South Africans should be investing offshore. Important reasons include:

- portfolio diversification;
- South Africa's relative size as a mature emerging market;
- risk reduction and performance; and
- geographical segmentation.

The aforementioned reasons plus the devaluating rand provides good reasons why a prudent investor can enhance risk adjusted returns by investing offshore.

5.2 DIVERSIFICATION

The most important reason for investing offshore is to obtain the benefits of diversification (spreading of risk). The principal of diversification (or don't put all your eggs in one basket) is widely accepted by international investors.

Markowitz was the pioneer behind the development of modern portfolio theory and the implications of this theory on diversification. Modern portfolio (or investment) theory suggests that the investor earns a return for foregoing the use of their capital, plus a premium for risk. The investor expects a higher return for a given perceived risk, or less risk for a given expected return. Investors will accept additional perceived risk only if accompanied by additional expected returns (Greer and Farrell, 1984:21).

Modern portfolio theory deals mainly with investors' concern of how risk will affect their total return and, according to Markowitz, rational investors should select investment portfolios yielding the highest possible return for a specified level of risk (Dobbins, Witt and Fielding, 1994:12).

According to Hendriksen and Van Breda (1992:179) and Ross, Westerfield, Jordan and Firer (1999:319), the most important implication of modern portfolio theory is that it is not the risk and return of individual securities that are important, but rather a securities contribution to the overall risk and return of the portfolio. The concept of diversification flows directly from this principle, meaning that investors can reduce their level of investment risk through diversification and therefore earn the same expected return but at a lower level of risk. While security returns are correlated and tend to move together, either up or down, there exists a degree of independence among the sources of risk affecting the different securities in an investment portfolio.

Diversification implies that the risk of an investment portfolio will decrease significantly with the addition of securities to the portfolio. Due to the cost of diversification, investors and portfolio managers would benefit from knowing what

the minimum number of securities would be required, in a portfolio, to eliminate its diversifiable risk. Before answering the aforementioned, diversifiable and non-diversifiable risk will briefly be introduced.

According to Ellis (1983), Ross et al. (1999:315), Dobbins et al. (1994:8) and Rosenberg (1991), the total risk of investing in securities can be divided into two components, namely:

- diversifiable (specific or unsystematic) risk; and
- non-diversifiable (market or systematic) risk.

Diversifiable risk comprises two further types of risks, both of which can be avoided by diversification (Rosenberg, 1991:21). The first is specific risk, which is the risk that the price of an individual security will behave differently (due to economic, political, business risks or numerous other factors unique to the security or the company) from the market. The second is the 'extra-market risk', which is the risk that a group of securities will behave differently from the overall market (Rosenberg, 1991:21). Both the aforementioned risk types are avoided by creating portfolios that replicate the market. According to the same source, this process of replication is really an exaggerated form of diversification. Because diversifiable risk is relatively easily avoided, by diversification (in efficient markets), rational investors would receive no additional reward (or return) for bearing this risk (Chen, Roll and Ross, as cited in Rosenberg, 1991:21).

Non-diversifiable (market or systematic) risk is inherent to the market as a whole and cannot be eliminated. The risk can, however, be increased by gearing, or reduced by spreading, an investment over several markets (Rosenberg, 1991:21). Several markets could include equities, fixed interest investments, property and, most importantly, exposure to other offshore markets. This risk that cannot be diversified away represents the risk that affects all securities in the market to a greater or lesser degree. This risk would encompass aspects such as changes in inflation, interest rates, foreign exchange rates, taxation, oil prices, government fiscal and monetary policy, recessions and wars.

A completely diversified portfolio, in an efficient market, is one where all the risk is market related. Diversifiable risk can be diversified away by adding shares to the portfolio, but a portfolio's comovement with the market, non-diversifiable risk, is impossible to totally eliminate. Stated differently – the market risk stays with all the securities that comove with it, and that includes nearly all the securities. A portfolio risk thus approaches the market risk when its size nears that of the market. It can be said that the return of a well diversified portfolio is highly correlated with the market and its risk (the variability of returns) is basically the risk of the market as a whole.

The question regarding the number of shares required in a portfolio, to eliminate diversifiable risk, may be answered by looking at results achieved by various researchers. Research done by De Villiers and Favis (1999:86) concludes that, “nearly all the reduction in first order risk (average standard deviation) in a portfolio has taken place once the first ten shares have been included.”

De Villiers and Favis (1999:86) go on to say that, “for a portfolio of ten shares second order risk (the variability of the standard deviation) remains high.” They also say that their results “support those of Davidson and Meyer (1993:45), who argue that second order risk explains the use of large institutional investors. These large institutions are better able to diversify away second order risk than the individual investor could. Investors may therefore be using large institutions as investment vehicles to reduce second order risk.”

Diversification thus tells us that spreading an investment across many assets and markets will eliminate some of the risk (the diversifiable risk) and that there is a level of risk that cannot be eliminated by diversification (non-diversifiable risk). Diversification can reduce risk, but only up to a point. Stated differently, some risk is diversifiable and some is not.

Although diversification has very important benefits (reduces risk), it does not provide a method whereby investors can select an optimal or efficient portfolio. Efficient portfolios are evaluated according to expected risk and returns and are

those portfolios that provide the lowest risk for a given return. It is from these efficient portfolios that investors should select the optimal portfolio to best suit their investment needs (Dobbins et al., 1994:22).

5.2.1 Diversifiable (specific or unsystematic) risk and international diversification

As already stated, an investment portfolio's total risk (represented by its standard deviation) consists of diversifiable (specific or unsystematic) risk plus non-diversifiable (market or systematic) risk. The purpose of diversification is to reduce the risk (standard deviation) of the total portfolio. This assumes imperfect correlations among securities. Ideally, securities with negative (or low) correlations should be added to the portfolio.

An unsystematic risk is one that affects a single security or a small group of securities. Because these risks are unique to individual companies or assets, they are sometimes called unique or asset-specific risks.

According to Du Plessis (1992:75), the specific or unsystematic risk of an individual company or asset class is determined by its business risk. The inability of a company or security to maintain its competitive position and the growth or stability of its earnings, either temporarily or permanently, is referred to as business risk (Amling, 1984:25). Business risk is affected by internal and external factors.

Internal factors would include the optimal utilisation of company assets, quality of management, productivity, financial risk (the uncertainty introduced by the method of financing) and numerous other factors that will influence the operating results.

External factors would include liquidity risk (the uncertainty associated with the secondary market for the security), exchange rate risk (the uncertainty of returns associated with investing in a currency other than one's home currency), country

or political risk (the uncertainty of returns associated with changes in the political or economic environment of a country).

Specific (or unsystematic risk) is the component of total risk that an investor is not compensated for bearing. By diversification the prudent investor can eliminate specific or unsystematic risk.

All the components of business risk will not be discussed; only the components of business risks (internal and external) that are inherent and unique to most South African companies and securities will be mentioned and commented on. It could be argued that some of the business risk components mentioned could also be classified as systematic risk. Of importance is not whether these components are systematic or unsystematic risks, but rather that they can be eliminated by diversifying offshore. The following components of business risk will be briefly discussed:

- Lack of international competitiveness;
- Corruption, crime and corporate governance;
- Productivity and skills shortage;
- AIDS/HIV virus;
- Country or political risk;
- Economic growth; and
- Exchange rates and exchange rate risk.

5.2.1.1 Lack of international competitiveness

South Africa (SA) signed the General Agreement of Tariffs and Trade (GATT) in 1993, agreeing to liberalise trade and reduce import taxes and export subsidies. SA business now faces international competition. According to Du Toit (1998:62), "International competitiveness is defined by the Institute for Management Development (IMD) as the ability of a country to create added value and thus increase national wealth by managing assets and processes, attractiveness and aggressiveness, globality and proximity, and by integrating these relationships into an economic and social model."

The IMD identifies the following eight main determinants of competitiveness of companies and nations:

- Domestic economic strength – overall performance of the economy.
- Internationalism – the extent to which a country participates in international trade and the flow of investments.
- Government – the nature of government policies, particularly the extent to which they help or hinder competitiveness.
- Finance – the performance of capital markets and the quality of financial services.
- Infrastructure – the adequacy of resources and systems to meet the basic needs of business.
- Management – the extent to which firms are managed innovatively, profitably and responsibly.
- Science and technology – the success of both applied and basic research.
- Quality of people – the availability and quality of human resources (Mohr, 2000:225).

Table 5.1 indicates the ranking of some of the 47 countries surveyed for the 2000 World Competitiveness Scoreboard of the IMD.

Table 5.1 World Competitiveness Scoreboard (Selected Countries, 1996-2000)

Country	1996	1997	1998	1999	2000
United States	1	1	1	1	1
Singapore	2	2	2	2	2
Ireland	22	15	11	11	7
Hong Kong	3	3	3	7	14
Japan	4	9	18	16	17
Taiwan	18	23	16	18	22
Malaysia	23	17	20	27	25
Chile	13	24	26	25	26
Italy	28	34	30	30	30
China	26	27	24	29	31
Mexico	42	40	34	36	36
Czech Republic	34	35	38	41	37
South Africa	44	44	42	42	38
Turkey	35	38	33	37	42
India	38	41	41	39	43
Indonesia	41	39	40	46	45
Russia	46	46	46	47	47

Source: International Institute of Management Development (as cited by Forgey, Dimant, Corrigan, Mophuthing, Spratt, Pienaar and Peter, 2001:463).

South Africa ranked 38th among the 47 countries surveyed during the 2000 year. The IMD calculates its scoreboard on the basis of a number of 'input factors', covering both 'hard data' (such as statistics), and 'soft data' (interviews with executives in the countries in question).

According to the aforementioned report, South Africa's international competitiveness (and therefore South African business and securities) is influenced by the following various strengths and weaknesses:

Strengths include –

- Rich in metal and mineral resources.
- Abundant energy resources.
- Vast tourist attractions.

- Well-developed and diversified agricultural, financial and industrial sectors.
- High-technology strategic industries.
- Advanced research institutions.
- Well-developed economic infrastructure.
- Relatively low foreign debt ratios compared to other Third World countries.

Weaknesses include –

- A relatively high population growth rate.
- A multi-cultural society (many racial groupings, many languages and religions).
- Socio-political factors (uncertainty, violence, mass action).
- Crime and corruption.
- Extensive social needs (housing, health care, education and training).
- Fiscal constraints (a small tax base, budget deficit, government debt).
- A vulnerable balance of payments (volatile capital flows).
- Labour market conditions (high unemployment, low average skill level, high number of strikes, low productivity, high unit labour costs, punitive labour legislation).
- Scarce water resources and a harsh climate (impact on agricultural output and industrial and domestic water usage).
- The country's geographic position (communication with and transport to and from major trading partners relatively expensive and time consuming).

Saul Klein, an authority on international business from Wits Business School, made the following statements regarding South Africa's lack of international competitiveness:

- Business South Africa is not catching up fast enough to its international competitors in efficiency and market responsiveness.
- Trade liberalisation is the key to competitiveness. Open up the market and let it determine its competitiveness.
- Foreign direct investment (FDI) is driven by prospects of returns. South Africa has been stumbling along receiving \$200 million of FDI since 1994 compared with \$40 billion in China.

- South Africa's export performance has been weak, partly due to poor customer orientation.
- The reputation of South African businesses as unreliable suppliers is also of concern.
- The tolerance of mediocrity, "often with the excuse of affirmative action", is self-destructive (Matimulane and Legodi, 2001).

Mr Kevin Wakeford, chief executive officer of the South African Chamber of Business, says that fixed capital formation (investment in such things as machinery) dropped from 23% of Gross Domestic Product (GDP) in 1975 to 16% in 1999. "The economy, in terms of our capital base, looking at fixed assets, is, in fact, a depreciating economy" (Forgey, Dimant, Corrigan, Mophuthing, Spratt, Pienaar and Peter, 2001:448).

A report drawn up for the American Chamber of Commerce in South Africa by an economist at the University of the Witwatersrand, Professor David Solomon, said that South Africa had "yet to attract serious levels of investment from the US or any other country". South Africa suffered from a "range of ill-considered and inconsistent government policies", such as over-regulation of the labour market; the use of tax incentives which were uncertain and inconsistent with trade policies; and the remnants of exchange control. South Africa had in its favour a good financial system, and trade opportunities within the Southern African Development Community (Forgey et al., 2001:448).

All the aforementioned indicate that, by world standards, South Africa is not a very competitive country in which to invest.

5.2.1.2 Corruption, crime and corporate governance

Corruption, crime and violence are used by the IMD as 'input' factors when calculating a country's competitiveness. A fair portion of corruption and crime occurs in corporate South Africa, as well as in the National, Provincial and Local level of the Executive. South African business bears substantial costs regarding

these evils. These additional costs negatively influence corporate earnings and returns obtained on various securities.

The annual Corruption Perception Index of the international anti-corruption organisation, Transparency International (TI), revealed that South Africa received a score of 4,8 (Van der Merwe, 2001).

This index measures the degree to which corruption, in the main bribery, is perceived to exist among public officials and politicians. The index was compiled from the results emanating from 14 international surveys. The results of the different international surveys are then statistically standardised to arrive at a score out of 10, for every country surveyed. Countries are ranked from high (perceived to be less corrupt) to low (perceived to be more corrupt).

Crime costs the country some R30 billion a year, according to Dr Mark Welman, director of the MTN Centre for Crime Prevention Studies at Rhodes University (Forgey et al., 2001:76).

Although South Africa has adequate guidelines in corporate governance (as set out in the King Report), the effect on corporate behaviour has been minimal. The investment public, locally and abroad, has watched in horror as allegations of corporate deception, self enrichment, inside and reckless trading have emerged from commissions of inquiry into Leisure Net, Regal, Masterbond, Supreme and the arms deal, to name but a few.

5.2.1.3 Productivity and skills shortage

Productivity can be defined as the ratio between output (goods and services produced) in the economy, and the input of resources (capital, labour, energy, land and entrepreneurial talent) used to produce the output (Du Toit, 1998:32).

According to the same source, important factors that are having an adverse effect on productivity growth in South Africa are:

- the lack of high-level manpower and management skills;
- obsolete technology, mainly due to sanctions and disinvestment in the 1980s and early 1990s, as well as the high cost of replacement, owing to an ever-depreciating exchange rate;
- lack of awareness and knowledge regarding productivity standards on the part of the majority of the population;
- ineffective competition, deregulation and commercialisation;
- political factors (violence, poor labour relations and strikes, often resulting in the unproductive utilisation of scarce resources);
- the high level of crime;
- social factors such as poor health, housing, transport and social and physical security conditions;
- cultural differences.

According to the aforementioned source, the previously mentioned factors may cause a low-productivity trap. The low productivity trap functions as follows:

- as a result of low-productivity growth the unit cost of production rises,
- this causes the price of goods and services to increase,
- resulting in sluggish (less) sales,
- resulting in a lower utilisation of plant capacity, and
- finally resulting in lagging capital formation.

According to PE Corporate Services, South Africa experienced a shortage of managerial and technical staff during the 2000/2001 years. This consultancy estimated that South Africa faced a shortage of between 350 000 and 500 000 people in the managerial and technical sectors and a shortage of 250 000 people in the information technology sectors (Forgey et al., 2001:363).

Despite South Africa having the largest economy within the Southern African Development Community (SADC), the country has been reclassified as a lower-middle-income country compared to having been in the upper-middle-income group in the past. The main reason for the aforementioned is South Africa's continuously poor economic performance over the years compared to other regional economies (Du Toit, 1998:14).

The World Bank distinguishes between low-income economies, low-middle-income economies, upper-middle-income economies and high-income economies.

The SADC is made up of the following 14 countries: Democratic Republic of Congo, Angola, South Africa, Tanzania, Namibia, Mozambique, Zambia, Botswana, Zimbabwe, Malawi, Lesotho, Swaziland, Mauritius and Seychelles.

5.2.1.4 AIDS/HIV virus

Health is an important component of human development in any country/region and obviously has an economic impact as it influences productivity in the workplace. The cost of providing health care services also has a financial impact because it is funded by the private and public sectors.

The Acquired Immune Deficiency Syndrome (AIDS) and the Human Immunodeficiency Virus (HIV) is increasingly having a serious economic, social and demographic impact in South Africa and sub-Saharan Africa. Sub-Saharan Africa is all countries (including South Africa) without a Mediterranean coastline.

Facts and figures regarding AIDS/HIV are widely published, debated and disputed. The serious economic, social and demographic impact on South Africa can be illustrated by considering the following information:

- In 1999, the United Nations Population Division projected that 50% of the under-five child mortality in South Africa will result from AIDS (Du Toit, 2000:8).
- Approximately 15% of all South African adults aged 20 to 64 are currently infected, and these levels could rise to 20-23% by 2005 and 22-27% by 2010.

HIV is a disease that mostly affects younger people, with around half of all adults who acquire HIV becoming infected before they turn 25. Over 50% of these young people will die of AIDS before their 35th birthday (Abt Associates Inc., 2001:6).

During the period 1994 to 2001 there has been an exponential growth of HIV infection in South Africa. This growth has been accompanied by greater visibility of the epidemic, especially owing to the increasing number of AIDS cases and deaths. Experts agree that South Africa now faces one of the world's most severe HIV/AIDS epidemics (Abt Associates Inc., 2001:3).

- According to recent estimates from the Joint United Nations Progress on HIV/AIDS (UNAIDS) and the World Health Organisation (WHO), 34,7 million adults and 1,4 million children were living with HIV worldwide at the end of 2000. In addition, the epidemic has created a cumulative total of 13,2 million AIDS orphans. In 2000, an estimated 600 000 children aged 14 or younger became infected with HIV. Almost nine-tenths of these new infections occurred in sub-Saharan Africa. The overwhelming majority of HIV infections, around 95% of the global total, live in the developing world. This is a proportion that is set to grow even further as infection rates continue to rise in countries where poverty, poor healthcare systems, and limited resources for effective prevention and care fuel the spread of the virus. Sub-Saharan Africa is the worst affected region, having around 70% of the global total of HIV positive people (Abt Associates Inc., 2001:4).

The International Monetary Fund distinguishes between industrial countries (see 23 countries listed below) and developing countries (the rest).

The 23 industrial countries are: Belgium, Denmark, France, Germany, Greece, Holland, Ireland, Italy, Luxembourg, Portugal, Spain, United Kingdom (all these countries represent the European Union), Australia, Austria, Canada, Finland, Iceland, Japan, New Zealand, Norway, Sweden, Switzerland and the United States (Mohr, 2000:221).

- "HIV/Aids knows no boundaries of class, states, race or sexual preferences. The epidemic has claimed 23 million lives worldwide; it is estimated that 36 million are incubating HIV" (Makgoba, 2001:18). Makgoba is president of the Medical Research Council (MRC) of South Africa.

- After the release of the MRC report on 'The impact of HIV/AIDS on adult mortality in SA', the Government and Statistics SA disputed its findings and the methodology used.
- Makgoba answered the MRC report's critics as follows: "If a snake comes into your house, don't waste time asking where it came from; kill it first and ask questions afterwards" (Makgoba, 2001:18).
- The World Health Organisation (WHO) health report for the year 2000 reported that South Africa's healthcare system ranks 175 out of 191 member countries (*Business Day Survey*, 2001:2).
- According to *Business Day Survey* (2001:2), Stephen Kramer (manager of AIDS research at Metropolitan Life) says: "HIV-related absenteeism, loss of productivity and the cost of replacing workers lost to AIDS threatens the survival of a number of businesses and industrial sectors." He goes on to say that "the direct cost of AIDS will be felt through escalating employee and medical scheme costs. The cost of an average set of benefits is expected to almost double by 2005 and triple by 2010" (*Business Day Survey*, 2001:9).
- Business would have to bear additional costs (in the form of additional health and insurance benefits, as well as training and replacement costs, and some of this would lead to higher producer price infiltration (*Business Day Survey*, 2001:9).
- Gross Domestic Product (GDP) growth would be curtailed by the impact of AIDS. South Africa was also likely to suffer constraints in respect of savings, which could reduce the scope for new investment. Perceptions of greater risk associated with the country, as a result of AIDS, could also make it more difficult to attract much needed foreign capital (*Business Day Survey*, 2001:9).
- Clem Sunter, chairman of the Anglo American Chairman's Fund, says, "Businesses will have to intensify their prevention efforts aimed at their workforce and the communities in which employees live." HIV/AIDS is a complex subject with many facets, but he says, "when you take the clutter away, it boils down to one thing: changing the sexual behaviour of young people" (*Business Day Survey*, 2001:1).

5.2.1.5 Country or political risk

The political risk rating of a country is considered to be the risk of non-payment or non-servicing of loans, trade-related finance, dividends, imports of goods and services, and the non-repatriation of capital (Du Toit, 2000:30).

Risk assessments done by Institutional Investors (II), Euromoney, Moody's, Standard and Poor's and Fitch International Banking Credit Association are based on political and economic factors.

Institutional Investors' country credit ratings for emerging and developing countries worldwide are based on the assessment of the following factors, in each country (ranked according to importance):

- Debt service;
- Political outlook;
- Financial reserves and current account;
- Economic outlook;
- Trade balance;
- Fiscal policy;
- Foreign direct investment;
- Inflow of portfolio investments; and
- Access to capital markets

(Du Toit, 2000:30).

In the Institutional Investors' country credit rating survey of March 2000, South Africa was ranked 58th out of a total number of 145 countries worldwide. In terms of Africa, Botswana was first out of 39 countries, followed by Mauritius (second), South Africa (fifth) and Zimbabwe (fifteenth) (Du Toit, 2000:30).

Moody's, which rates more than 100 countries, has put South Africa on review for an upgrade from its present investment grade Baa3. The Baa3 ranking ranks South Africa with Croatia, El Salvador, Mexico, Saudi Arabia, Thailand, Trinidad, Tobago and Uruguay (Hazelhurst, 2001:47).

The Moody's symbols mean the following:

Aaa	Prime, maximum safety
Aa1	High grade, high quality
Aa2	
Aa3	
A1	Upper medium grade
A2	
A3	
Baa1	Lower medium grade
Baa2	
Baa3	
Ba1	Non investment
Ba2	Speculation
Ba3	
B1	Highly speculative
B2	
B3	
Caa	Substantial risk
Ca	Extremely speculative
C	May be in default

(Hazelhurst, 2001:47).

5.2.1.6 Economic growth

The ultimate aim of economic policy is usually to improve the standard of living of the population, in per capita (or per head of the population) terms. Most investors are aware that businesses do not exist in isolation but form part of an economic system. The prosperity and success of businesses is usually greatly affected by the economic systems in which they operate. Accordingly, investors are usually very aware of economic factors (GDP growth, taxation, various business cycles, balance of payments, interest and inflation rates) that affect the businesses and securities in which they invest.

The aforementioned is amplified by the present situation in Zimbabwe. Due to dismal economic and political factors, investment performance is very negatively affected.

Long term investors adopting a passive investment strategy will be less concerned with the aforementioned economic factors. Passive investment style investing will be discussed in the next chapter.

Gross domestic product (GDP) is a popular method used for measuring total economic activity in a country. GDP is defined as the total value of all goods and services produced within the geographic boundaries of a country, in a particular period (usually a year) (Mohr, 2000:19). To achieve the ultimate aim of economic policy (which is to improve the standard of living of the population), economic growth must be sustainable and continuously higher, in real terms, than the population growth. Due to continuously poor economic growth, the World Bank has downgraded South Africa from an upper-middle-income country to a lower-middle income country (Du Toit, 2000:14).

Tables 5.2 and 5.3 provide data regarding real growth in GDP and income levels, as well as mid-year estimates of South Africa's population estimates for the years 1991 to 2000 (inclusive).

Table 5.2 Real growth in GDP and income levels 1991-1999^a

Year	Real total GDP Rbn	Increase (decrease) ^b	Real GDP per head ^c R	Increase (decrease) ^b	Real personal disposable income per head ^d R	Increase (decrease) ^b
1991	519,72	(1,0%)	14 352	(3,1%)	9 060	(1,6%)
1992	508,61	(2,1%)	13 755	(4,2%)	8 825	(2,6%)
1993	514,89	1,2%	13 637	(0,9%)	8 709	(1,3%)
1994	531,54	3,2%	13 786	1,1%	8 683	(0,3%)
1995	548,10	3,1%	13 920	1,0%	8 870	2,2%
1996	570,86	4,2%	14 197	2,0%	9 126	2,9%
1997	585,10	2,5%	14 249	(0,4%)	9 150	0,3%
1998	589,12	0,7%	14 048	(1,4%)	9 010	(1,5%)
1999	600,16	1,9%	14 013	(0,3%)	8 880	(1,4%)

Source: South African Reserve Bank (as cited in Forgey et al., 2001:425).

a At constant 1995 prices.

b As calculated by the South African Institute of Race Relations, on the basis of figures from the South African Reserve Bank. Figures in this table may differ slightly from those provided by Statistics South Africa.

c GDP per head is total GDP divided by the total population.

d Personal disposable income per head is total personal income minus direct taxes.

Table 5.3 Population size 1991-2000

Mid-year estimates of the South African population by race 1991-2000 ^a						
Year	African	Coloured	Indian	White	Unspecified	Total ^b
1991	27 400 100	3 254 000	960 300	4 238 000	346 500	36 198 900
1992	28 072 000	3 317 200	976 000	4 274 800	351 900	36 991 800
1993	28 759 800	3 381 400	991 900	4 311 900	357 200	37 802 200
1994	29 463 700	3 447 000	1 008 100	4 349 100	362 600	38 630 500
1995	30 184 400	3 513 600	1 024 400	4 386 600	368 200	39 477 100
1996 ^c	30 921 700	3 581 600	1 040 900	4 424 400	373 700	40 342 300
1997	31 676 600	3 650 700	1 057 900	4 462 200	379 400	41 226 700
1998	32 449 200	3 721 000	1 074 900	4 500 400	385 100	42 130 500
1999	33 239 100	3 792 600	1 092 300	4 358 700	390 800	43 054 300
2000 ^d	33 879 900	3 796 900	1 092 500	4 521 700	394 800	43 685 700
Increase 1991-2000	23,6%	16,7%	13,8%	6,7%	14,0%	20,7%

Source: Statistics South Africa (as cited in Forgey et al., 2001:49).

a Natural increase based on the 1996 census and an estimation of fertility and mortality. Figures exclude nett migration. Figures for 1991-1995 have been adjusted using backward projections of the 1996 census results and inferring the rate of increase from the totals (including former 'independent' homelands). Figures have been rounded.

b Figures should add up horizontally but may not, owing to rounding.

c Mid-year estimate, not census figure.

d Not including additional deaths caused by HIV/AIDS.

Real GDP grew by 13,7% between 1991 and 1999, although there were periods of contraction during this time, most notably in 1992. Population size increased by almost 19% over the same period. Due to the aforementioned, real personal disposable income per head declined from R9 060 in 1991 to R8 880 in 1999. This performance over the past decade has been most disappointing. The longer real disposable income per head stagnates, the more fears there are that racial division will become more bitter and divisive.

What is also of concern is that when the world economy was booming during 1999-2000, South Africa's GDP growth was very disappointing. The aforementioned can be observed from Table 5.4. This table provides growth records for a number of widely differing economies between 1997 and 2000.

Table 5.4 Growth records for a number of widely differing economies between 1997 and 2000

Country	(GDP) 1997	1998	1999	2000	Aggregate 1997-2000
Egypt	5,3%	5,7%	6,0%	5,1%	22,1%
Iran	3,4%	2,2%	2,5%	3,6%	11,7%
Jordan	3,1%	2,9%	3,1%	4,0%	13,15%
Cameroon	5,1%	5,5%	4,4%	4,2%	19,2%
Mozambique	11,1%	11,9%	7,3%	3,8%	34,1%
Tanzania	3,5%	3,3%	4,8%	5,1%	16,7%
Uganda	5,1%	4,6%	7,6%	4,6%	21,9%
India	4,9%	6,0%	6,6%	6,4%	23,9%
Pakistan	1,8%	2,6%	4,3%	5,1%	13,8%
Bangladesh	5,3%	5,0%	5,2%	5,0%	20,5%
China	8,8%	7,8%	7,1%	7,8%	31,5%
Malaysia	7,3%	-7,4%	5,8%	8,5%	14,2%
Korea	2,6%	6,8%	6,3%	4,1%	20,0%
Chile	7,4%	3,9%	-1,1%	5,4%	15,7%
Mexico	6,8%	4,9%	3,8%	6,9%	22,4%
Trinidad	3,1%	4,8%	6,8%	5,6%	20,0%
Poland	6,8%	4,8%	4,1%	4,1%	21,8%
Hungary	4,6%	4,9%	4,5%	5,3%	19,3%
and among the world's losers (less than 10% aggregate) are ...					
Nigeria	3,9%	1,1%	1,1%	2,8%	8,9%
SOUTH AFRICA	2,5%	0,7%	1,9%	3,1%	8,2%
Zimbabwe	3,7%	2,5%	-0,2%	-5,5%	0,5%
Zambia	3,5%	-2,2%	2,4%	4,0%	7,7%
Indonesia	4,5%	-13,1%	0,8%	4,8%	-3,0%
Libya	-1,2%	2,9%	2,5%	3,0%	7,2%
Brazil	3,3%	0,2%	0,8%	4,2%	8,5%
Paraguay	2,6%	-0,4%	0,5%	0,8%	3,5%
Jamaica	-1,7%	-0,5%	n/a	1,5%	-0,7%
Russia	0,9%	-4,9%	3,2%	7,5%	6,7%
Ukraine	-3,3%	-1,9%	-0,4%	4,2%	-1,4%

Source: Preece, 2001:15.

There is no escaping the fact that South Africa has a poor economic growth record, even well after the ending of all the anti-apartheid sanctions. Poor economic growth plus substantial population growth compounds South Africa's problems. Other economic factors contributing to economic growth and reasons for the poor economic growth rate will not be discussed, as it falls beyond the ambit of this assignment.

According to Du Toit (1998:20), efforts to increase South Africa's potential economic growth rate may require a combination of the following policies:

- The expansion of export-orientated policy measures;
- An improvement in the country's terms of trade;
- An increase in domestic savings and investment;
- Continuously sound fiscal and monetary policies;
- The privatisation of state assets;
- A nett inflow of foreign capital;
- An increase in the size of the skilled labour force;
- A lower population growth rate;
- A much lower crime rate.

5.2.1.7 Exchange rates and exchange rate risk

An exchange rate is the price of one country's currency (e.g. the rand) in terms of another country's currency (e.g. the US dollar) (Mohr, 2000:147). Most countries use the direct method to express exchange rates. With this method the exchange rate shows how much of the local currency (rands) has to be exchanged for one unit of a foreign currency (e.g. the US dollar). The direct method thus indicates the domestic price of the foreign currency. With the indirect method the exchange rate is expressed as the amount of foreign currency that is required to purchase one unit of the domestic currency.

The international abbreviation for the South African rand is ZAR and for the US dollar it is USD. All quoted exchange rates are nominal bilateral exchange rates,

since they are expressed in money terms and involve the currencies of two different countries. It is also important to distinguish between spot exchange rates and forward exchange rates. A spot exchange rate is the rate at which foreign exchange is bought and sold for immediate delivery, while a forward exchange rate pertains to foreign exchange bought and sold for delivery on a future date (Mohr, 2000:148). The exchange rate quoted at any particular time (in money terms) is the nominal exchange rate. For analytical purposes a real exchange can also be calculated by taking price movements into account (Mohr, 2000:149). For example, in the case of South Africa and the United States, the (bilateral) real exchange rate between the rand and the dollar is determined by adjusting the nominal exchange rate by the ratio of South African prices to United States prices. The underlying principal is that a proportionally higher increase in the domestic prices of South African products, relative to the domestic prices of United States products, will affect the competitiveness of the South African economy if this differential price movement is not neutralised by a corresponding adjustment of the exchange rate between the two currencies (Mohr, 2000:149).

An overall measure of the movement of the rand against the major currencies is obtained by calculating an effective exchange rate. The effective rate is a weighted average rate that is derived by weighting the exchange rates between the rand and the main currencies, using the different countries' shares in South Africa's foreign trade as weights (Mohr, 2000:151). The real effective exchange rate is obtained by adjusting the nominal effective exchange rate by the effective foreign price ratio. The effective foreign price ratio is the trade-weighted ratio between South African prices and prices in the economies of our main trading partners (Mohr, 2000:151).

Table 5.5 shows the value of the rand in American cents from 1970 to 1999, as calculated by the Bureau for Economic Research at the University of Stellenbosch, and thereafter the index of the real average effective exchange rate as calculated by the Reserve Bank (Forgey et al., 2001:453).

Table 5.5 The value of the rand in American dollars and cents from 1970 to 1999

Year	Value of commercial rand in US dollars	Increase (decrease)	Index of real effective exchange rate ^a (average)	Increase (decrease)
1970	1,40	N/A	93,57	N/A
1971	1,40	0,0%	94,91	1,4%
1972	1,29	(7,9%)	89,11	(6,1%)
1973	1,44	11,6%	98,56	10,6%
1974	1,47	2,1%	99,46	0,9%
1975	1,35	(8,2%)	101,14	1,7%
1976	1,15	(14,8%)	99,57	(1,6%)
1977	1,15	0,0%	104,23	4,7%
1978	1,15	0,0%	101,78	(2,4%)
1979	1,19	3,5%	107,27	5,4%
1980	1,28	7,6%	118,75	10,7%
1981	1,14	(10,9%)	120,27	1,3%
1982	0,92	(19,3%)	112,83	(6,2%)
1983	0,90	(2,2%)	124,32	10,2%
1984	0,68	(24,4%)	105,93	(14,8%)
1985	0,45	(33,8%)	82,02	(22,6%)
1986	0,44	(2,2%)	85,58	4,3%
1987	0,49	11,4%	99,84	16,7%
1988	0,44	(10,2%)	95,78	(4,1%)
1989	0,38	(13,6%)	95,39	(0,4%)
1990	0,39	2,6%	97,37	4,8%
1991	0,36	(7,7%)	102,06	4,8%
1992	0,35	(2,8%)	104,35	2,2%
1993	0,31	(11,4%)	103,14	(1,2%)
1994	0,28	(9,7%)	101,52	(1,6%)
1995	0,28	0,0%	99,98	1,5%
1996	0,23	(17,9%)	93,67	(6,3%)
1997	0,22	(4,3%)	99,68	6,4%
1998	0,18	(18,2%)	90,46	(9,2%)
1999	0,16	(11,1%)	85,83	(5,4%)

Source: Bureau for Economic Research, South African Reserve Bank (as cited in Forgey et al., 2001:453).

a 1990 = 100.

N/A – Not Available.

On 20 December 2001 the rand slumped to a new low of R13,85 to the USD. The rand has recovered and, at present (16 January 2002), is trading at R8,74 to the USD. The extent of the depreciation can be further amplified by looking at various organisations' forecasts of rand performance, made for 2000 and the ensuing three years.

Table 5.6 Various organisations' forecasts of rand USD exchange rates

	2000	2001	2002	2003
Rand/USD exchange rate (average)				
Absa	6,81	7,22	7,47	—
Bureau of Economic Research, University of Stellenbosch	6,85	7,20	—	—
Standard Bank	6,90	7,67	7,96	8,28
First National Bank	7,00	7,60	7,80	8,00
Nedcor	7,09	7,79	8,25	8,67

Source: Bureau of Economic Research, University of Stellenbosch (as cited in Forgey et al., 2001:490).

The extent by which the aforementioned respected organisations under-forecasted the depreciation of the rand against the USD is alarming. The Department of Finance believes the rand could depreciate to as low as R26,00 to the USD by 2018, after dropping to about R14,90 to the USD by 2010 (*Mail and Guardian*, 2001).

The reason why the rand USD exchange rate has been emphasised is due to the immense role the United States of America plays in the world economy. This is mentioned in section 5.3.

There are many reasons forwarded for the dismal performance of the rand. These include:

- Poor sentiment rather than fundamentals is driving the currency, and this will continue to ensure that there is a greater demand for US dollars (Mnyanda, 2001:26).
- It is not so much aversion to South African politics, but pessimism about the outlook for the prices of resources that South Africa (and Australia) supply to world markets that is responsible for rand (and Australian dollar) weakness (Kantor, 2001:16).
- The failure of the African National Congress (ANC) to deal convincingly with AIDS and increasing repression in Zimbabwe (*Mail and Guardian*, 2001 – author unknown).
- Inadequate levels of gross foreign exchange reserves, including gold.
- A residual overhanging burden from nett uncovered foreign exchange liabilities (the much touted nett open forward position).
- The Argentinean debt crisis.
- According to Preece (2001:21), “a chronic shortage of foreign capital inflows for long-term fixed investment (or gross capital formation, as it is now officially called); and an export base which though it has been generally successful in recent years, remains vulnerable to adverse trends of international commodity markets; politically Mbeki is at best seen in First World financial centres as still unproven and at worst as ultimately hostile to what are commonly regarded as Western interest and values; South Africa’s biggest problem is that economic growth is far too low, that leads to few profitable opportunities for foreign investors in this country; the crash of the rand depreciation is essentially a reflection of what is happening to emerging market returns overall.”
- According to Jos Gerson, chief economist at Merrill Lynch, as cited in *Business Times Staff* (2001:15), a number of factors are chiefly responsible for the depreciation of the rand. These include the plunge of the platinum price, the slowdown in the global economy, and uncertainty over the listing of Telkom.

According to President Mbeki, “there is no logic to the steady erosion of the foreign exchange value of the rand way beyond any inflation-differential compensation when set against the basically sound fiscal and monetary policies pursued in South Africa” (Preece, 2001:21).

When the Finance Minister Trevor Manuel and Director-General Maria Ramos are questioned regarding the performance of the rand, they provide their stock answers – that there is no real reason to worry about the rand’s decline as South Africa’s fundamentals remain sound (*Business Times Staff*, 2001:15).

According to Bullard (2001:4) “the rand is valued exactly where it ought to be”. He goes on to say: “The rand falls sharply in reaction to some bad news, recovers a little, stabilises for a while and then falls again in response to some new fear. That has been the problem over the past seven years and you would need to munch a few magic mushrooms to believe the future will be any different. So let’s not worry about the currency because it’s probably where it should be, no matter how often the pundits argue that it is undervalued. If people thought the rand was undervalued they would buy it. They don’t. So it isn’t.”

It is interesting to note that the actual purchasing power of the rand has not declined in the same dramatic way as the currency market would indicate. A loaf of bread in the United States or Germany is not $\pm 40\%$ more expensive in rands since the beginning of this year. This test is known as the purchasing power parity and, if applied to South African currency, one could declare the rand to be undervalued.

Another predictive tool for currency watchers is to track South African inflation against that of our trading partners and to expect a depreciation, in rand value, by the difference between the inflation rates.

However, of relevance is a trend that is unlikely to change in the foreseeable future and the implications of the rand depreciation for investors.

South African investors can protect themselves from becoming poorer, in global terms, by investing in securities that are denominated in hard (stronger) currencies. When funds are invested offshore the rand amount is converted from rands to the hard currency at the time of the investment, at the exchange rate applicable at that date (e.g. R6,15 to 1 USD). Whenever the South African investor considers it appropriate to remit the investment, the currency is converted back to rands at, say, R12,15 (on 28 December 2001). Growth is therefore achieved in two instances, via the depreciation of the rand against the other currency and, hopefully, the underlying securities performance.

In the event of the rand strengthening against the other currency, an exchange rate loss may be realised. More commentators are, however, of the opinion that the rand will continue depreciating until the inflation differential has been eliminated between South Africa and its major trading partners.

Exchange rate risk is the uncertainty of returns to an investor who acquires securities denominated in a currency different from his or her own (Reilly and Brown, 2000:20). A South African investor who buys Japanese shares denominated in yen must consider not only the uncertainty of the return in yen, but also any change in the exchange value of the yen relative to the South African rand.

Considering the aforementioned inflation rate differential and the trend of the rand weakness against other hard currencies, the probability of major rand appreciation (against hard currencies) seems most unlikely.

5.2.1.8 Empirical evidence

According to Ross et al. (1999:312), an unpublished study on the Johannesburg Stock Exchange (JSE) by Professor Dave Bradfield of the University of Cape Town's Department of Statistical Sciences, indicated that the standard deviation of both the average share and a well-diversified portfolio on the JSE are some two percentage points higher than those found by Elton and Gruber on the New York

Stock Exchange (NYSE). Professor Bradfield (as cited in Ross et al.) also says that approximately five more shares were needed to create a 'completely' diversified portfolio, and that South African shares have a proportionately higher percentage of non-diversifiable (market) risk than those on the NYSE. The aforementioned findings accord with the idea that the South African economy is less diversified than that of the United States.

If a South African investor held a single South African security, then the value of the security would fluctuate because of the security – and country-specific events. If the same investor held a large portfolio of international securities, on the other hand, some of the securities in the portfolio will go up in value because of positive security (company) – and country-specific events. Some will go down in value because of negative events. The nett effect on the overall value of the portfolio will be relatively small, however, as these effects tend to cancel each other out. The important result of eliminating unsystematic risk, via diversification, is enhanced by incorporating offshore securities in the South African investor's portfolio. The aforementioned is achieved because foreign assets will possess different business risks as well as significantly different country risks.

In a study on the impact of international diversification, it was shown that allowing South African investors to put equal investments into the local market and 17 foreign stock exchanges resulted in an increase in average returns over a 14-year period from 16,4% to 17,9%, but a decrease in average risk from 26,6% to 9,5% (Ross et al., 1999:312). The rationale for international portfolio diversification is that foreign securities should be expected to have low covariances with a portfolio of domestic securities (Solnik and Noetzlin, 1982:11-21).

In recent years, researchers Van den Honert and Affleck-Graves (1985) and Bhana (1985 and 1986), have submitted that South African investors would have derived substantially greater benefits by including foreign securities in their portfolios. These researchers have shown that the inclusion of foreign securities would result in superior portfolio returns being generated when compared with returns derived from investments exclusively in South African securities.

Furthermore, the South African investor is able to accomplish significant risk reduction when overseas securities are added to these portfolios (Bhana and Konar, 1992/1993:22).

Barr (1986:41) also demonstrated that South Africa can be expected to experience volatile exchange rate movements in the future. Foreign securities would serve as an excellent rand hedge for South African investors.

In summary, because a well-diversified portfolio is highly uncorrelated with the market, and its risk (or variability of returns) is basically the risk of the market as a whole, it is prudent to diversify. The only risk a well-diversified portfolio thus has to contend with is the market or systematic risk. No extra reward can be earned by (needlessly) bearing unsystematic risk.

5.2.2 Non-diversifiable (market or systematic) risk and international diversification

The two components of total risk, as previously identified, are specific (or unsystematic) risk and market (or systematic) risk. Factors affecting the unsystematic risk that are unique to South African companies and securities were discussed in the previous section. The importance of diversifying the specific risk was also discussed. It is generally accepted that the unsystematic component of total risk can be diversified away by holding a well-diversified portfolio of assets. Therefore, to the well-diversified investor, only the systematic component of total risk should be of concern.

Market or systematic risk cannot be diversified away and represents the risks that affect all securities in the market (Dobbins et al., 1994:8). Systematic risk includes general economic conditions, the impact of monetary and fiscal policies, inflation, political and other events that affect all securities in the market.

The distinction between unsystematic and systematic risk is often not clear. Making the exact distinction between the two aforementioned risks is, however,

not of vital importance. What is important is the fact that South African investors can:

- eliminate unsystematic risk by investing in a diversified offshore portfolio; and
- that although systematic risk cannot be eliminated, it can be reduced by global diversification. The aforementioned is achieved due to the fact that some of the systematic risk factors in the South African market, for example, the South African monetary policy, are uncorrelated with systematic risk variables in other countries such as the United States, Japan and Germany. By diversifying globally one eventually gets down to a world systematic risk level (Reilly et al., 2000:293). This systematic risk level would be lower than the South African market's systematic risk.

5.2.2.1 Beta and correlation coefficient

Since systematic risk is the crucial determinant of a security's or portfolio's return, some method of measuring the level of systematic risk was required. The specific measure used is called the beta coefficient (β). Systematic risk, as measured by the beta coefficient, indicates the sensitivity of the security's return in respect to the movements of the returns of the market portfolio. Expressed another way, the beta coefficient is the slope of the best fitting line drawn through a plot of excess returns on the security against excess returns on the market. The beta coefficient indicates how much systematic risk a particular security has relative to an average security. By definition, on average, asset (or security) has a beta of 1 relative to itself (Ross et al., 1999:320). The beta is measured by the covariance of the security and market returns, divided by the variance of the market returns.

The beta coefficient is derived from the CAPM, which states that, in equilibrium, the expected return of a security or portfolio is related to both the 'risk free' return plus the return on the market portfolio. The risk free return is generally measured by the return on treasury bills or government stock. The market portfolio used in CAPM is theoretically assumed to contain all risky assets available to the investor. Almost all empirical studies of the CAPM have used some market index (Standard and Poor's 500 Composite Index, JSE Overall Actuaries Index, etc.) as a

surrogate for the market portfolio (Bhana et al., 1992/1993). This is a gross understatement of the market portfolio because the composite market indices only include securities that are listed on a given stock exchange. The true market portfolio should ideally comprise all risk assets as well as equities listed on all stock exchanges (Bhana et al., 1992/1993).

As stated in Chapter 4, correlation coefficients measure the degree with which two variables, such as the returns on two securities, move together. Correlation takes on a numerical value between +1,0 to -1,0. The sign (either a + or a - indicates whether the returns move together (+) or inversely (-). If the correlation is negative (-), the variables being measured move inversely, that is, when the return for one variable decreases, the return on the other variable increases.

5.2.2.2 International empirical evidence

According to Bodie, Kane and Marcus (2001:643), "there is a marked reduction in risk for a portfolio that includes foreign as well as United States stocks, so rational investors should invest across borders. Adding international to national investments enhances the power of portfolio diversification."

Due to factors already mentioned in sections 5.2.1.1 to 5.2.1.8, the size of South African markets (relative to world markets), compounded by local currency weakness, amplifies the benefits of across-border (international) diversification.

From the aforementioned, as well as the results of empirical studies that will be discussed hereafter, it appears that risk (systematic risk) may be reduced by international diversification. International diversification entails investing in various assets and securities in different countries. These assets and securities, in various countries, expose the South African investor to different exchange rate risks, liquidity risks, country or political and business risks.

Grubel's (1968) study (as cited in Laubscher, 2001:8) confirmed that United States investors could construct international investment portfolios, which render higher

returns or bear lower risk than could be achieved with domestic portfolios. The same source also says that two United Kingdom studies of Levy and Sarnot (1970) and Dimson, Hodges and Marsh (1980) concurred with Grubel's findings and found that the largest benefits from international diversification occur when investments are not limited to North America and Western Europe, but also include Japan, South Africa and other developing countries. Laubscher (2001:8) also says that a 1985 study of Ibbotson, Siegel and Love examined performances of numerous assets around the world and they also constructed portfolios consisting of shares, bonds, cash, real estate and precious metals for their research into the possible benefits of international diversification. These assets were selected from markets in Australia, Canada, Japan, Hong Kong, Europe, Singapore and the United States. This study found that systematic risk factors in one country are not correlated with those in other countries. It concluded that global diversification can reduce a portfolio's systematic risk to a world systematic risk level. Reilly and Brown (2000:293) concurred with the aforementioned findings.

Reilly and Brown (2000:94) constructed a correlation matrix of selected United States and world assets. The correlation matrix indicates that United States equities have a reasonably high correlation with Canadian and United Kingdom equities. The authors go on to say that international investors would be wise to build a diversified portfolio by combining those world assets with low or negative correlations in a diversified portfolio.

According to Reilly and Brown (2000:99), "studies on the historical rates of return for common stocks and other investment alternatives (including bonds, commodities, real estate, foreign securities, and art and antiques) point towards two generalisations:

- A positive relationship typically held between the rate of return earned on an asset and the variability of its historical rate of return. This is expected in a world of risk-averse investors who require higher rates of return to compensate for more uncertainty.

- The correlation among rates of return for selected alternative investments is typically quite low, especially for United States and foreign stocks and bonds and between these financial assets and real assets, as represented by art, antiques and real estate. This confirms the advantage of diversification among investments from around the world.”

Bodie, Kane and Marcus (2001:643) concur with Reilly and Brown.

Diversification comes from holding investments that have uncorrelated returns. The aforementioned empirical studies, from primary and secondary sources, indicate that global diversifications beneficial results are derived from the relatively low correlation between the returns of different countries. However, it remains difficult to intuitively grasp the size of these diversification effects. According to Professor Ian Cooper (2001:5), Steven Henston of Goldman Sachs and academic Geert Rouwenhorst have provided a useful benchmark by examining returns to see how international diversification compares with diversification within a single country. They found that “diversification across countries within an industry is much more effective for risk reduction than industry diversification within a country.” In other words, according to them, the first and most important dimension of portfolio diversification is internationalism.

5.2.2.3 South African empirical evidence

Van den Honert and Affleck-Graves (1985) showed that both the London Stock Exchange and the New York Stock Exchange offered considerable advantages to the South African investor for diversification purposes.

Bhana (1985 and 1986) showed that South African investors would have improved the risk-returns characteristics of their investments by pursuing international diversification during the period 1969-1983. Due to the rapid depreciation of the rand since 1983, the aforementioned researchers findings would be amplified.

According to Bradley, Higgins and Abey (2000:76), “there are usually fundamental reasons why some economies do well when others do poorly.” South Africa’s commodity-based economy tends to do well when commodity prices are high. In contrast, Japan’s economy is more devoted to adding value to raw materials and is more likely to do well when commodity prices are low.

Table 5.7 indicates the correlation, for major share and bond markets, among six countries. The correlations between South African markets and many international markets are surprisingly low.

Table 5.7 Risk, return and correlations of international shares and bonds in rands, 1990 to 2000

			Correlations					
	Return %	Volatility %	Australia	Germany	Japan	UK	USA	South Africa
Equities								
Australia	14,41%	25,17%	1,00					
Germany	20,71%	20,47%	0,56	1,00				
Japan	5,19%	29,01%	0,64	0,34	1,00			
United Kingdom	30,74%	16,12%	0,67	0,69	0,48	1,00		
United States	26,01%	19,85%	0,60	0,66	0,47	0,70	1,00	
South Africa	11,12%	24,71%	0,46	0,24	0,30	0,13	0,24	1,00
Bonds								
Australia	19,57%	15,67%	1,00					
Germany	15,94%	16,40%	0,44	1,00				
Japan	20,70%	14,18%	0,38	0,64	1,00			
United Kingdom	21,67%	17,50%	0,55	0,81	0,53	1,00		
United States	17,34%	11,11%	0,63	0,78	0,54	0,88	1,00	
South Africa	16,10%	2,87%	-0,23	-0,62	0,34	-0,65	-0,66	1,00

Source: INET and IPAC South Africa (as cited in Bradley et al., 2000:77).

Theory says that a South African investor should look at investing in offshore markets that have a low correlation in relation to the South African market.

Studies done by IPAC South Africa showed that “even a rudimentary application of international diversification would have produced a better result than sticking with domestic markets” (Bradley et al., 2000:79).

The aforementioned researchers have all concluded that South African investors would have derived substantial benefits (higher returns and lower risk) by including foreign securities into their portfolios. Thus the investors’ efficient frontier graph (risk/return) would improve by making use of international diversification.

All the aforementioned research was, however, based on ex post data (based on actual historical results). Because their research was conducted retrospectively, it gave researchers the opportunity to review past investment results and then to ‘pick winners’ from the various international share and bond indices. These ‘winners’ could then have been included in their international diversified portfolios.

If past results are considered to be indicative of future development, then these results suggest that future international diversification of portfolios is likely to be profitable for South African investors.

According to Bhana (1989/90), “Makridakis and Wheelwright have demonstrated that, in order to realise the potential gains from portfolio diversifications, the investor must be able to predict future relationships among the price movements of two or more different stock exchanges. This condition must be satisfied before the ex post benefits of international diversification can be realised on an ex ante basis.” An ex ante basis means based on forecasts rather than actual post (ex post) returns. According to Bhana (1989/90), Watson showed that the aforementioned condition would be fulfilled if the relationships between national stock exchanges were stable over time. Bhana’s (1989/1999) research showed that, from a South African investor’s standpoint, the following two necessary conditions, for successful international portfolio diversification, appears to be satisfied so far as the 18 countries used in the study are concerned over the 1969-1983 period:

- the inter-country correlations, in general, did not vary significantly with time during the period covered by the study; and
- inter-country correlation coefficients were found to be substantially less than plus one.

Bhana does go on to say that “a major limitation of this study is that the empirical evidence is based on ex post data which may not be a good proxy for expected future returns. In order to demonstrate the likely benefit available from international diversification, it is considered necessary for future studies to construct internationally diversified portfolios on an ex ante basis and to compare the results of such portfolios with the results of domestically diversified portfolios.” Considering the aforementioned limitation, this study does suggest that ex post inter-country correlation coefficients can be used to achieve gains and risk reduction from international portfolio diversification.

Another important South African study conducted by Bhana and already mentioned, as cited in Ross et al. (1999:312), confirmed the benefits of international diversification and found that South African investors can significantly reduce investment risk and increase investment returns by investing part of their funds in international markets. This study allowed South African investors to place equal investments into the local market and 17 foreign stock exchanges. This investment strategy resulted in an increase in average returns, over a 14-year period, from 16,4% to 17,9%. More importantly, was the decrease in average risk from 26,6% to 9,5%.

A very interesting study done by Barr (1986), over the period 1973 to 1985, proved that the benefits from foreign diversification manifest themselves in one of two forms, either as:

- an increase in the return achieved; and/or
- a decrease in the risk associated with the diversified portfolio.

Barr basically compared ex post portfolio returns and risks (in percentage a year) for various portfolio combinations of three markets. The markets he used were the New York Stock Exchange (NYSE) Standard and Poor's Composite Index, the

Financial Times United Kingdom Actuaries Index on the London Stock Exchange and the JSE Actuaries All Share Index. All three indices used are market-capitalisation type indices. He used five portfolios, invested as follows, and measured the return and risk of each portfolio:

Table 5.8

Portfolios	Average return	Average risk
Portfolio 1: 100% of funds invested in South Africa	7,35%	7,12%
Portfolio 2: 90% of funds invested in South Africa 5% of funds invested in United States 5% of funds invested in United Kingdom	8,35%	6,30%
Portfolio 3: 80% of funds invested in South Africa 10% of funds invested in United States 10% of funds invested in United Kingdom	8,69%	5,36%
Portfolio 4: 50% of funds invested in South Africa 25% of funds invested in United States 25% of funds invested in United Kingdom	9,69%	3,22%
Portfolio 5: 33⅓% of funds invested in South Africa 33⅓% of funds invested in United States 33⅓% of funds invested in United Kingdom	10,17%	3,13%

Viewed overall over the period 1973-1985 it can be seen that portfolio 1 (100% invested in South Africa) produced a return that was on average 3% less than the return achieved in portfolio 5. Very importantly, the risk of the all-South African portfolio (portfolio 1) was double the risk of the portfolio consisting of equal investments in each of the three markets considered. According to Barr, the correlation (or comovement) of the three markets played a major role in the determination of the risk of a portfolio consisting of securities from all three markets. Over this period the average correlation between the JSE Actuaries All Share Index and the Standards and Poor's index on the NYSE was close to zero, as was the average correlation between the South African exchange and the United Kingdom Actuaries Index on the LSE. If the securities had been negatively correlated, even greater benefits would have been obtained. Barr said that this study has the following implications for offshore diversification in the future:

- The substantial rand returns achieved for holdings in the NYSE or the LSE could not be used as an indication of future portfolio returns. The aforementioned is due to the fact that the dramatic fall in the rand value against other currencies, due to, among other reasons, increased political instability, contributed to the rand returns.

Current exchange rate data, however, reveals that the rand continued its substantial depreciation against the dollar over periods (1986 to 2001), after Barr concluded his study.

The rand reached a record daily average low on 20 December 2001, when one US dollar was worth R13,85.

- South Africa's economic performance tends to move counter cyclically to that of the United States.

As South Africa has entered a period of considerable uncertainty regarding the value of its currency and thus the wealth of its residents, the argument is stronger than ever for some forms of international diversification.

5.3 SOUTH AFRICA'S RELATIVE SIZE AS A MATURE EMERGING MARKET

According to Kreitler (2000:5), *The Wall Street Journal* of 26 June 1997 classified existing world markets in five major groups.

Table 5.9 Classification of world markets

Developed markets	Other developed markets	Mature emerging markets	Newly emerging markets	Frontier markets
Australia	Austria	Argentina	China	Egypt
Canada	Belgium	Brazil	Colombia	Jordan
Denmark	Finland	Chile	Czech Republic	Morocco
France	Hong Kong	Greece	Hungary	Nigeria
Germany	Italy	Korea	India	Pakistan
Ireland	Japan	Malaysia	Indonesia	Peru
Netherlands	Norway	Mexico	Israel	Russia
New Zealand	Singapore	Philippines	Poland	Turkey
Sweden	Spain	Portugal	Sri Lanka	Zimbabwe
Switzerland		South Africa	Taiwan	
United Kingdom		Thailand	Venezuela	
United States				

Source: *The Wall Street Journal*, 26 June 1997 (as cited in Kreitler, 2000:5).

The aforementioned world markets were grouped, according to Kreitler, using factors that include performance, value, risk, market regulation and efficiency, economic health, capitalisation and liquidity. According to Bodie, Kane and Marcus (2001:638), one of the main indicators of whether a country is classified as developing or emerging is the level of per capita GNP. According to the aforementioned classification, South Africa is one of 11 mature emerging markets in the world. According to Kreitler (2000:225), "developed markets are defined as those twenty one markets around the world with a proven history of relatively strict regulator climates. Developing or emerging markets are defined as those markets around the world that are growing and progressing but that do not yet have a proven regulatory climate."

In a report on global equity market capitalisation and global portfolio shares in 1997, South Africa accounted for 0,95% of the global portfolio. The countries representing the largest share of the global portfolio were:

- United States, which represented 47,84% of the global share portfolio;
 - Japan, which represented 12,93% of the global share portfolio;
 - United Kingdom, which represented 9,28% of the global share portfolio;
 - Germany, which represented 3,77% of the global share portfolio;
 - France, which represented 3,05% of the global share portfolio
- (Bodie, Kane and Marcus, 1999:787).

Due to significant rand-dollar depreciation, delisting of De Beers Consolidated Mines Limited, as well as various major South African listed companies moving their head offices and major listings offshore, South Africa's representation in the world share portfolios would not have been enhanced.

Selected extracts from a table providing data on equity market capitalisation, Gross National Product (GNP), percentage of GDP, number of listed corporations and GNP/capital, reveals the following:

Table 5.10 Data on market capitalisation, GNP, %GDP, number of listed corporations and GNP/capita

	Market capitalisation	GNP	% of GDP	Number of listed corporations	GNP/capita
Developed markets					
United States	11 309	7 783	144	8 851	29 080
Japan	2 217	4 812	53	2 387	38 160
United Kingdom	1 996	1 231	155	2 046	20 870
Germany	825	2 321	39	700	28 280
Australia	697	383	177	1 219	20 650
Netherlands	469	403	130	201	25 830
Emerging markets					
China	231	1 055	23	764	860
South Africa	171	130	180	642	3 210
Argentina	45	319	18	136	8 950
Zimbabwe	1	8	22	64	720

Notes

- Market capitalisation in US\$ billions as at the end of 1998.
- GNP in 1997, US\$ billion.
- Column 4 relates to capitalisation as a percentage of GDP (not GNP), and is not equal to column 2/column 3.
- Number of listed corporations as at the end of 1997.

Source: World Bank (as cited in Bodie, Kane and Marcus, 2001:639).

Figures showing the breakdown of securities available in world capital markets in 1998, indicate that emerging market equities represent 1,2% and emerging market debt represents 1,6% of all securities available in world capital markets (Reilly and Brown, 2000:71).

Considering the aforementioned facts and figures, it should be obvious to the South African investor that, by limiting their investments to the local market, they are severely restricting their range of investment opportunities and are being myopic. They will not be exposed to the major opportunities in developed (lower

risk) markets, nor will they share in the growth and development in, especially, the health (pharmaceutical), technology and communication sectors. The opportunity of investing in developed or other developed markets, with a low correlation to the South African market, enhances the reasons for South Africa to maximise the usage of their offshore investment allowance.

5.4 PERFORMANCE AND RISK

5.4.1 Domestic savings

Investing could be regarded as deferred expenditure. Defer present expenditure so that savings may be utilised at a future date.

According to Du Toit (1998:24), personal savings rates (personal savings as a percentage of personal disposable income) decreased from 9,3% per annum on average during the 1960s to 8,4% per annum during the 1970s, to 4,2% per annum during the 1980s and to 2,7% per annum during 1990-1997.

According to Forgey et al. (2001:441), personal savings rates had decreased to 0,7% in 1998 and to 0,3% during 1999. The same source also states that household debt to personal disposable income had increased from 38,9% in 1980 to 52,2% in 1990 and to 58,1% in 1999.

Considering the aforementioned low savings rates, it is imperative for South African investors to maximise their risk adjusted investment returns. South Africans can protect themselves from becoming poorer, in global terms, by diversifying their investments into developed markets (lower risk) assets or securities, which are denominated in hard (stronger) currencies.

Modern investment theory suggests that the investor earns a return for foregoing the use of his capital, plus a premium for risk. The investor expects a higher return for a given perceived risk, or less risk for a given expected return. He will

accept additional perceived risk only if accompanied by additional return (Greer and Farrell, 1984:21).

According to the CAPM, the analysis and comparison of any investment performance cannot be based on returns alone. To enable comparison on an equal basis, an investment performance measure must combine risk and returns. This is because investors are considered to be risk-averse, and risk levels differ between different types of investments.

It is generally accepted that an efficient portfolio should produce the highest expected return for a given level of risk or the lowest level of risk for a given level of expected return. Therefore, to assess a proper measure of investment performance, the ex post average return of a security or a portfolio of securities over a given time must be adjusted for the risk of the return over the same time period.

The total risk is usually measured by the standard deviation of return of the security and the portfolio. The importance of risk and the two components of risk, namely unsystematic and systematic risk, have already been discussed in section 5.2.

Historical rates of returns will be discussed in the remainder of this section.

5.4.2 Historical rates of return

Not everyone agrees on the value of studying history or historical returns. On the one hand, there is philosopher George Santayana's famous comment: "Those who do not remember the past are condemned to repeat it." On the other hand, there is industrialist Henry Ford's equally famous comment: "History is more or less bunk" (Ross et al., 1999:273).

While taking cognisance of the following factors, historical rates of return remain important to most investment consultants and potential investors:

- the remarks of various researchers (section 5.2.2.3) regarding historical (ex post) returns;
- asset classes (e.g. shares and bonds) returns and risk vary over time and that no single asset class continuously outperforms in all economic environments; and
- historical performance is most definitely no guarantee of future asset class performances.

Optimisation of investment performance is usually the primary objective of any investor. Historical empirical rates of return (see Table 5.11) clearly indicate the importance of placing investment in the correct asset classes (e.g. shares or bonds) to optimise risk-adjusted returns. Other factors, including diversification, risk and time horizons, should also be considered before investors decide on appropriate asset allocations.

Historical returns is a useful, but by no means the only input that should be considered when planning an appropriate asset allocation and/or security selection. Nevertheless, historical performance is a useful input to consider. Empirical historical performance should be contemplated and, importantly, possible facts that could cause a change in historical performance should be identified, considered and assessed.

5.4.2.1 South African historical rates of return

Data or information on South African investment returns is only available from 1960 onwards (Ross et al., 1999:278). Table 5.11 provides rates of return for the JSE all share index, gilts, fixed deposits, and the inflation rate. The returns could be interpreted as what the investors would have earned had they held the various portfolios in various calendar years.

Winston Floquet, formerly chairman of Fleming Martin, and author of a 20-year study on the performance of different asset categories, has studied the performance of gilts and equities in various countries. Some of the results of his work are used in this assignment.

Table 5.11 South African five-year rolling periods (with pre-tax income reinvested)

Compound annual rates of return (capital and income)							
	EQUITIES ¹		GILTS ²		FIXED DEPOSITS ³		INFLATION
5 years 1 Jan-31 Dec	Nominal % p.a.	Real % p.a.	Nominal % p.a.	Real % p.a.	Nominal % p.a.	Real % p.a.	Cpi % p.a.
1960-1964	12,9	10,9	6,4	4,4	4,2	2,2	2,0
1961-1965	17,5	15,2	3,0	0,7	4,5	2,2	2,3
1962-1966	19,6	16,8	3,3	0,5	4,8	2,0	2,8
1963-1967	17,9	15,0	-0,7	-3,6	5,1	2,2	2,9
1964-1968	22,7	19,5	-0,4	-3,6	5,7	2,5	3,2
1965-1969	15,9	12,8	0,7	-2,4	6,2	3,1	3,1
1966-1970	7,7	4,2	1,4	-2,1	6,5	3,0	3,5
1967-1971	5,6*	1,6	1,5	-2,5	6,9	2,9	4,0
1968-1972	12,4	7,3	2,8	-2,3	7,1	2,0	5,1
1969-1973	4,9*	-1,7	3,4	-3,2	7,1	0,5	6,6
1970-1974	10,4	1,8	0,5	-8,1	7,2	-1,4	8,6
1971-1975	14,2	4,2	3,4	-6,6	7,7	-2,3	10,0
1972-1976	11,4	0,7	3,8	-6,9	8,1	-2,6	10,7
1973-1977	6,3*	-5,2	3,9	-7,6	8,5	-3,0	11,5
1974-1978	11,7	-0,2	6,1	-5,8	9,0	-2,9	11,9
1975-1979	23,4	11,5	10,6	-1,3	9,3	-2,6	11,9
1976-1980	35,8	23,2	6,9	-5,7	8,8	-3,8	12,6
1977-1981	36,7	23,4	6,8	-6,5	8,7	-4,6	13,3
1978-1982	37,6	23,8	10,6	-3,2	9,1	-4,7	13,8
1979-1983	32,9	19,2	4,4	-9,3	9,7	-4,0	13,7
1980-1984	18,8	5,3	1,0	-12,5	11,2	-2,3	13,5
1981-1985	18,7	4,6	5,1	-9,0	13,4	-0,7	14,1
1982-1986	29,6	14,7	11,6	-3,3	14,5	-0,4	14,9
1983-1987	21,4	6,3	8,2	-6,9	14,2	-0,9	15,1
1984-1988	21,3	5,9	11,9	-3,5	13,8	-1,6	15,4
1985-1989	30,1	14,3	17,4	1,6	13,6	-2,2	15,8
1986-1990	20,3	5,3	18,8	3,8	13,4	-1,6	15,0
1987-1991	16,3	1,6	14,8	0,1	13,8	-0,9	14,7
1988-1992	16,6	3,0	16,5	2,9	14,9	1,3	13,6
1989-1993	23,9	10,9	22,5	9,5	15,2	2,2	13,0
1990-1994	18,1	6,2	13,2	1,3	14,4	2,5	11,9
1991-1995	21,3	10,9	17,3	6,9	13,6	3,2	10,4
1992-1996	17,1	8,0	14,8	5,7	13,1	4,0	9,1
1993-1997	16,5*	8,2	16,6	8,3	12,9	4,6	8,3
1994-1998	4,7*	-3,5	9,3	1,1	13,2	5,0	8,2
1995-1999	10,5*	3,8	20,2	13,5	14,1	7,4	6,7
Averages							
- Of 5-year periods	18,5	8,7	8,4	-1,4	10,1	0,3	9,8
- Over 40 individual years	19,9	10,7	9,5	0,3	10,0	0,8	9,2
Standard deviation (40-year term)	24,9						

*Five year periods during which equities failed to achieve the highest return.

¹All share index²20-year gilts³1-year fixed deposits

Source: Floquet, W., 2000. Investment comparisons. Fleming Martin Research, South Africa, 29 February 2000.

The following important comments regarding rates of returns, as presented in Table 5.11, need to be made:

- **Income Tax**

All the historical rates of return used in this assignment are before-tax returns. The investment with the highest yield is not necessarily always the best investment. Investors need to optimise after-tax returns or yields. The interest earned on fixed-interest investments is usually fully taxable subject to the R4 000 exemption for taxpayers under the age of 65 and a R5 000 exemption for taxpayers of 65 or older (Section 10(1)(i) of the Income Tax Act, as amended).

A useful formula for the calculation of after-tax returns is as follows:

Nett after-tax yield = gross yield $\times [(100 - \text{investor's marginal tax rate}) \div 100] + \text{tax exempt yield}$.

- **Equities**

According to Ross et al. (1999:279), who also commented on Table 5.11, "this portfolio is composed of the approximately 149 shares that make up the JSE all share index. This index consists of the largest shares in each section of the JSE, which cumulatively represents 80% of the market capitalisation of their sector. This portfolio therefore consisted of the largest companies listed on the JSE."

- **Gilts**

This is a portfolio of 20-year South African government and semi-government bonds (known as gilts), which were rebalanced at the end of each year to maintain the term of the portfolio at 20 years. The data set therefore represents the returns an investor, who remained invested in gilts with a maturity of 20 years, would have earned.

- **Fixed Deposits**

According to Floquet (2000:3), this is a portfolio of 12 months to maturity fixed deposits.

- **Inflation (Cpi)**

The year-to-year percentage change in South African Consumer Price Index was also computed and is presented in Table 5.11. This is a commonly used measure of inflation and enables the investor to calculate real (after inflation) investment returns.

- **Period 1960-1994**

The bulk of the period covered by Table 5.11. During 1960-1994 the government of the day practised apartheid. Trade and financial sanctions were imposed against South Africa by most of the countries in the rest of the world. Capital inflows were restricted and there were few overseas buyers of South African securities and assets. South Africa became economically isolated from the rest of the world as foreign direct investment dried up. Foreign banks recalled their loans. Due to the aforementioned, a deficit on the balance of payments capital account resulted. The Nationalist government of the day attempted to resolve this problem by introducing higher import taxes on certain goods, thus discouraging imports. Local production was encouraged via various tax incentive allowances. For obvious reasons, exports were encouraged. Exchange control was introduced in 1961. This prevented South Africans from investing abroad. The aforementioned caused a 'hothouse effect' in South African securities because the only markets individual and corporate investors could utilise were South African markets.

Foreigners were also discouraged from taking money out of the country via the implementation of a dual currency system. A commercial rand for current account transactions (a cheaper exchange rate) and a financial rand for capital account transactions (a more expensive rate) were instituted. The aforementioned and numerous other factors suppressed economic growth in South Africa.

Mainly due to foreign disinvestment, a few large corporations gained a monopolistic hold on the South African economy. The top five companies controlled over 80% of the market capitalisation on the JSE from 1985 to 1995. In 1990, South Africa's political situation changed greatly with the release of Nelson Mandela. Large JSE conglomerates unbundled and became more competitive as South Africa became more 'acceptable' to the rest of the world. By 1998 the top five companies (largest companies) held $\pm 54\%$ of the JSE market capitalisation. South Africa abolished the dual currency system in 1995 and while exchange controls remain in place, they are progressively being eased (Bradley et al., 2000:24).

Due to South Africa's unique economic history and the fact that the bulk of the period reported on in Table 5.11 is affected by this history, investors need to deal with the historical returns circumspectly. Future rates of return as well as the risk environment may well be very different from those of the past.

5.4.2.2 Global historical rates of return

Table 5.7 presents risk, returns and correlations of international shares and bonds data, in rands, for the period 1990 to 2000. This data indicates that the correlations between South African markets and many international markets are surprisingly low. Returns and volatility of returns also differ greatly. All the aforementioned amplifies the merits of diversifying offshore.

Winston Floquet (2000:9) also produced average annual combined returns, in domestic currencies, for the period 1990-1999. This data is disclosed in Table 5.12. Note that these returns are in domestic currencies.

Table 5.12 Average annual combined returns (local currencies, 1990-1999)

Past 10 years	Equities	Bonds	Inflation
Australia	12,1	11,9	2,5
Germany	15,2	7,8	2,6
Japan	(1,1)	7,1	1,1
United Kingdom	15,4	11,6	3,8
United States of America	19,0	7,5	3,0
South Africa	16,5	18,1	9,3
France	17,4	9,4	2,0

Source: FT/S&P equity indices and J.P. Morgan bond indices (as cited in Floquet, 2000:9).

Floquet (2000:9) goes on to say: "Over the past 10 years equities have outperformed (bonds) in most countries, with only Japan and South Africa being the exceptions. In Japan equity valuations were excessive at the beginning of the period. South African bonds have also outperformed partially due to a change in government policy to allow real rates at the start of the measurement period. This provided some capital growth but the benefit came particularly from the high running yields which averaged 15,2%, significantly higher than in developed markets."

In Table 5.13 real (after inflation) returns are calculated by the author manipulating data provided in Table 5.12.

Table 5.13 Real (after inflation) average annual combined returns (local currencies, 1990-1999)

Past 10 years	Equities	Bonds
Australia	9,6	9,4
Germany	12,6	5,2
Japan	(2,2)	6,0
United Kingdom	11,6	7,8
United States of America	16,0	4,5
South Africa	7,2	8,8
France	15,4	7,4

Compared with major world markets, the South African equity market, considering the extra risk associated with investing in mature emerging markets and the inflation adjusted returns as reflected in Table 5.13, has performed relatively poorly over the last 10 years.

Because the data provided in Tables 5.12 and 5.13 was for relatively short periods (only 10 years), additional longer dated data will also be reviewed.

Selected extracts of data from a United States study done by Roger Ibbotson and Rex Sinquefeld, as cited in Reilly and Brown (2000:92), are presented in Table 5.14.

The aforementioned study commenced in 1926 and dealt with rates of returns in United States financial markets.

Table 5.14 Extracts from basic and derived series: Historical highlights (1926-1998)

	Arithmetic mean of annual returns	Standard deviation of annual returns
Large-company stocks	13,2%	20,3%
Small-capitalisation stocks	17,4%	33,8%
Long term corporate bonds	6,1%	8,6%
Long term government bonds	5,7%	9,2%
US Treasury bills	3,8%	3,2%
Consumer price index	3,2%	4,5%

Source: Roger Ibbotson and Rex Sinquefeld (as cited in Reilly and Brown, 2000:92).

Table 5.15 provides data regarding risk and return characteristics of stock (share) and bond investments in various countries. According to Bodie, Kane and Marcus (2000:640), “the first pair of columns are average returns in both local (or domestic) currencies as well as dollars, and the second pair are standard deviation in returns in both local currencies and dollars.”

Table 5.15 Risk and return for US dollar investors from international stock (shares), bonds and cash, 1971-1998

	RETURN		RISK	
	Average annual rate (%)		Standard deviation return (%)	
	In US dollars	In local currency	In US dollars	In local currency
Stocks				
France	14,6	14,7	23,4	21,3
Germany	15,0	11,9	20,4	18,2
Italy	9,3	13,2	26,7	25,6
Netherlands	17,9	15,2	17,8	17,3
Switzerland	15,8	11,2	19,7	17,4
UK	15,1	16,7	24,3	22,0
Australia	9,7	12,1	25,3	21,7
Hong Kong	17,3	18,9	40,8	38,7
Japan	13,9	9,3	23,1	18,7
Singapore	12,6	10,1	31,0	29,8
Canada	9,7	11,4	19,0	17,2
USA	13,4	13,4	15,3	18,3
Europe	14,2	14,2	16,8	14,1
EAFE	13,7	13,7	17,3	15,1
World	13,5	13,5	14,3	13,1
Bonds				
France	10,5	10,6	13,0	6,4
Germany	11,2	8,2	13,6	5,5
Italy	9,2	13,1	13,2	7,9
Netherlands	11,1	8,6	13,0	5,5
Switzerland	9,6	5,2	13,8	3,4
UK	9,7	11,2	15,8	10,1
Japan	12,1	7,6	15,0	6,0
Canada	7,6	9,3	10,9	8,5
USA	8,5	8,5	8,0	8,0
Cash				
France	10,0	10,1	11,1	0,0
Germany	9,0	6,0	11,7	0,0
Italy	8,6	12,5	10,3	0,0
Netherlands	9,1	6,6	11,4	0,0
Switzerland	8,8	4,5	13,5	0,0
UK	9,5	11,0	10,8	0,0
Japan	10,0	5,6	12,0	0,0
Canada	7,2	8,9	4,8	0,0
USA	8,2	8,2	0,0	0,0

Source: Bodie, Kane and Marcus, 2001. Essentials of Investments. McGraw-Hill Irwin, Singapore.

The primary reasons for including data per Tables 5.7 and 5.11 to 5.15 are to illustrate:

- the variability of the average annual rates of returns and the variability of the standard deviations of different asset classes in various countries; and
- to illustrate the significant impact the weaker rand has on boosting the outperformance of foreign markets (especially equities) from a South African investor's perspective. The aforementioned is clearly illustrated when considering rand returns per Table 5.16.

The aforementioned is amplified, from a South African investor's perspective, when looking at rand returns that would have been received in offshore markets, had exchange control not existed.

According to Floquet (2000:9), "the following table (Table 5.16) shows the growth in each country's equity index over the past 10 years (capital values, dividends ignored) converted back to rands." Thus the equity information per Table 5.12 was converted to rands as explained above.

Table 5.16 Various countries' equity index converted back to rands for the period 1990-1999

Country	1990	1999
Australia	100	374
Germany	100	618
Japan	100	207
United Kingdom	100	656
United States of America	100	1 018
France	100	675
South Africa	100	287

Source: Floquet, 2000:9.

“The aforementioned simply shows the relative growth in each index, adjusting for changes in the value of the rand, over the 10-year period. The impact of the weaker rand has been a significant influence in boosting the outperformance of foreign markets from a rand perspective” (Floquet, 2000:9).

Floquet (2000:9) then took the world equity and bond returns over the 10-year period (including income rollup) in US dollars and converted this to rands. The results are displayed in Table 5.17.

Table 5.17 Equity and bond returns over the 10-year period (including income rollup) in US dollars converting to rands

	1990	1999
Bonds		
JP Morgan (\$)	100	219
Converted to rands	100	529
SA 20-year gilt	100	470
Equities		
FT/S&P world (\$)	100	294
Converted to rands	100	709
South Africa all share	100	380

Source: Floquet, 2000:9.

According to Floquet (2000:9), the following can be concluded from the aforementioned:

- “SA bonds markets (in local currency) significantly outperformed global markets, the impact of the weak rand only just lifts global returns in rands above that achieved domestically.
- Local equity outperformance was not nearly as great. Investing offshore, with the benefit of the weak rand, would thus have been far more rewarding.”

The rand’s startling and significant depreciation since 1999 could amplify the aforementioned results.

5.4.2.3 Lessons from the past

From the aforementioned historical data the following general inferences can be made:

- If one assumes the risk premium for investing in cash or fixed deposits is zero, a risk premium may be calculated for investing in equity.

Table 5.18 Risk premium calculated for investing in equities over a 27-year period (1971-1998)

	Average Equity returns %	Average Cash returns %	Average Fixed deposit returns %	Risk premium %
Germany	11,9	6,0		5,9
Japan	9,3	5,6		3,7
United Kingdom	16,7	11,0		5,7
United States	13,4	8,2		5,2
France	14,7	10,1		4,6
South Africa	21,8		9,9	11,9

Source: The author compiled the contents of this table from selected extracts using data from Tables 5.11 and 5.15.

Over the 27-year period under review, South African investors received a relatively high risk premium (11,9%) for investing in a mature emerging market. The risk premium could have been affected by:

- the 'hothouse' effect that has already been alluded to;
- a change in government's policy allowing real rates of return at the start of 1990; and
- higher reward compensation for investing in a higher risk mature emerging market.

From data appearing in Floquet (2000:4), South African equity investors received the following risk premiums over the periods indicated (periods commenced in 1960):

Past 40 years	9,9%
Past 20 years	8,0%
Past 15 years	7,7%
Past 10 years	2,2%
Past 5 years	-1,2%

The standard deviation over a 40-year term amounted to 24,9%.

It appears that over shorter periods (past five and ten years), South African investors have not been well rewarded for investing in a more risky mature emerging market. South African equity investors could greatly reduce their risk by placing part of their equity investments offshore.

An important general inference is that equities, which is a risky asset class, on average earn a risk premium. Stated differently, there is a reward for bearing risk. This risk can, however, be reduced by diversifying offshore.

Empirical research done by Van den Honert and Affleck-Graves (1985) and Bhana (1985 and 1986), as discussed in section 5.2.2.3 clearly indicate the South African equity investors could improve their risk and returns by pursuing offshore investments. Other observations include:

- On average, bearing risk is rewarded. However, over short periods there is a significant chance of dramatic value fluctuations in equity investments. It could be said that the greater the potential reward, the greater the risk. Data presented in Table 5.15 indicates that risk-return profiles across developed – and other developed markets – are reasonably similar. However, because returns across countries are imperfectly correlated, there are great opportunities for gains from diversification internationally.

- The South African legacy of sanctions, exchange control, a closed and insular economy, the JSE being an investment 'hothouse' and a relatively insular investment community has lulled the average South African investor into a false sense of security and complacency.

The majority of South Africans have no or very limited offshore investment exposure. The bulk of their assets is invested in a mature emerging market, namely South Africa. Investors from countries classified as developed and other developed markets limit their asset exposure to mature emerging markets because of the higher risks inherent in these markets. Yet the South African investor with no or very little offshore exposure invests the bulk of their assets in a high risk mature emerging market with a rand that has depreciated considerably since 1970 (see Table 5.5).

The rand has strengthened to R8,74 to the US dollar (16 January 2003), from a low of R13,25 at the end of December 2002.

The volatility of the rand plus the trend of a depreciating currency (clearly indicated in Table 5.5) is disturbing.

5.5 GEOGRAPHICAL SEGMENTATION

Access to exposure to the world's major developed economies can only prove beneficial to the South African investor. It surely is not prudent to invest all one's funds in one politically unstable continent of the world?

5.6 SUMMARY

This chapter provided reasons why South Africans should invest offshore.

Diversification, the well accepted maxim of not placing all one's eggs in one basket, is the most important reason for investing offshore. Specific or unsystematic risk was discussed. Some unique problems and business risks facing corporate South Africa were considered. According to investment theory, an investor is not compensated for bearing specific risk and accordingly this risk should be eliminated by diversification.

Market or systematic risk was also reviewed. There is enough international and South African empirical evidence to suggest that, although market risk cannot be eliminated, it can be reduced by offshore diversification.

Other reasons mentioned were the relative size of South Africa as a mature emerging market, performance and risk and geographical segmentation.

Due to South Africa's unique past, the average South African has been lulled into a false sense of security and complacency.

Every prudent South African should make use of the risk return benefits of diversifying internationally.

CHAPTER 6

CHAPTER 6: AN OVERVIEW OF OFFSHORE INVESTMENTS

	Page
6.1 INTRODUCTION	103
6.2 OFFSHORE PRODUCTS IN GENERAL	103
6.2.1 Distinction between rand-denominated foreign investments and foreign-based offshore investments	104
6.3 RAND-DENOMINATED OR LOCALLY DOMICILED FOREIGN INVESTMENTS	106
6.3.1 Rand hedge equities	107
6.3.2 Assurance funds	109
6.3.3 Unit trusts	113
6.3.4 Tranches	116
6.3.5 Costs and transparency	117
6.3.6 Advantages and disadvantages	118
6.4 FOREIGN-BASED OFFSHORE INVESTMENTS	119
6.4.1 Financial Services Board approved investments	120
6.4.2 Equities and bonds	120
6.4.3 Assurance funds	123
6.4.4 Mutual funds	124
6.4.5 Standard and Poor's Depository Receipts, American Depository Receipts and World Equity Benchmark Shares	126
6.4.6 Property	128
6.4.7 Tank containers	128
6.4.8 Foreign currency bank accounts	129
6.4.9 Hedge funds	130
6.4.10 Options and warrants	131

		Page
6.4.11	Costs and cumulative break-even returns	132
6.4.12	Advantages and disadvantages	133
6.5	INTERNATIONAL INVESTMENT STRATEGIES AND INVESTMENT MANAGERS	134
6.5.1	International investment strategies	134
6.5.2	Portfolio management styles	135
6.5.2.1	Passive equity style investing	136
6.5.2.2	Active equity style investing	138
6.5.2.3	Passive and active bond style investing	142
6.5.3	Investment managers	143
6.5.3.1	Single fund managers	144
6.5.3.2	Fund of fund managers	144
6.5.3.3	Multi-managers	145
6.6	REGULATIONS APPLICABLE TO PRIVATE INDIVIDUALS INVESTING OFFSHORE	146
6.7	SUMMARY	148

Chapter 6

AN OVERVIEW OF OFFSHORE INVESTMENTS

6.1 INTRODUCTION

This chapter discusses the following topics:

- A distinction is made between the various offshore investments available to the South African investor. Rand-denominated or locally domiciled and foreign-based offshore investments are discussed. Various types of offshore investments and the costs associated with them are briefly discussed. The importance of making use of FSB approved funds is emphasised.
- Broad international investment strategies, passive and active equity, and bond styles. The modus operandi of single fund managers, fund of fund- and multi-managers is highlighted.
- Regularities and rules that private individuals wanting to invest offshore need to adhere to.

6.2 OFFSHORE PRODUCTS IN GENERAL

Prior to 1 July 1997, South African residents could only earn foreign currency via rand hedge shares and/or tank containers. Limited opportunities to invest via institutional investors (e.g. Sanlam, Old Mutual and others), making use of assets swaps, became available in December 1995. In March 1997, the Minister of Finance announced that as from 1 July 1997 South African residents would be allowed to invest R200 000 offshore (and/or hold foreign currency at local banks).

As already stated in Chapter 3, the remitable amount was increased by the Minister of Finance in the 1998 Budget speech to R400 000 and was increased to R500 000 in the 1999 budget. The current remitable amount of R750 000 was announced on 23 February 2000, with immediate effect.

The aforementioned amount of R750 000 can be invested in any offshore investment without any limitations. These would include share portfolios, bonds, unit trusts, property, and so on.

6.2.1 Distinction between rand-denominated foreign investments and foreign-based offshore investments

Offshore investments, for South Africans wanting to invest offshore, fall into two different categories:

- Rand-denominated foreign investments (previously known as asset swap investments). These are locally domiciled investments or funds; and
- Foreign-based offshore funds. These are externally domiciled investments or funds.

According to Oldert (2001(b):129), “understanding the difference lies in the word ‘domicile’, which literally means ‘home’ – where the fund ‘lives’.” According to the same source, “properly speaking, domestic funds which invest predominantly overseas are called Foreign funds (if they are geographically diversified) or Regional funds (if they concentrate on one region like Europe or the USA). The domestic funds which invest overseas do so using the asset swap mechanism permitted to local management companies.”

As stated in Chapter 3, the asset swap mechanism was terminated in the 2001 budget. Now institutions can invest up to the defined foreign assets limits (see Chapter 3) through cash transfers based on a prescribed percentage (currently 10%) of the previous year’s nett inflow of funds.

According to Kruger, De Kock and Roper (2001:163), investments made via the prescribed percentage of the institution’s nett inflow of funds do not form part of the investor’s R750 000 allowance. According to the same source, these investments have to be remitted to South Africa once the investment period has expired. Rands are thus initially converted into another currency (e.g. US dollars

or euros) and later converted back to rands (at prevailing exchange rates) when the proceeds of the investment are returned to South Africa. Important factors that distinguish rand-denominated investments from direct offshore investments are:

- Rand-denominated offshore investments may only be conducted through approved investment companies (approved investment companies are long term insurers, pension funds, fund managers and unit trust companies).
- The initial investment is made in rands, which are then converted to the applicable foreign currency. If the investment is made in an American product, then rands are converted to USD. When the investment is surrendered or matured, the investment proceeds must be converted back into rands (at the prevailing exchange rate) and paid back to South Africa.
- Rand-denominated offshore investments do not affect an individual's R750 000 international investment allowance. South African investors can thus use rand-denominated investments without the restriction of the exchange control investment allowance of R750 000.

According to Kruger, De Kock and Roper (2001:169), "a direct foreign investment is an investment into any offshore fund or asset in terms of which the funds physically flow offshore. The R750 000 allowance is utilised for these investments, thus South African Revenue Services (SARS) and South African Reserve Bank (SARB) approval is required. Rands are converted to another currency, which is utilised to buy the asset or to make an investment in a fund. The aforementioned may be redeemed and need not be converted back to rands (as is currently the case with a rand-denominated offshore investment)."

International or offshore investments and/or funds are basically divided into four categories, namely: equities, property, bonds and money markets. Numerous funds or investments combine the aforementioned categories across different markets, countries, sectors and assets. General investment maxims, like money market investments (e.g. savings and money market accounts) generally provide a lower and less volatile return than equities and bonds, are valid. Internationally, developed countries' bond markets usually provide South African investors a safe haven in that they provide security and growth in a declining interest rate

environment. The relatively low offshore interest rates (relative to South Africa), as well as possible gains available due to rand depreciation, also need to be considered. Equities offer potential growth but they are more volatile. The investor should be cognisant of the fact that he should be investing offshore to diversify his portfolio. Ideally, investments should be made in developed markets. The risk associated with the asset class should also be understood.

It is important to determine all costs associated before making any investments. Costs could include initial costs, annual costs, withdrawal or exit costs as well as hidden costs. All costs are not transparent.

Potential investors are assisted in terms of the Statutory notice to long term policyholders as well as the Financial Advisory and Intermediary Services Act, 2002. Both the aforementioned Acts make it mandatory to disclose all costs.

The writer's intention is not to mention or discuss every investment available, but rather to provide a general overview of offshore investments and their related costs. A summary of cumulative break-even returns and important advantages and disadvantages will also be discussed.

6.3 RAND-DENOMINATED OR LOCALLY DOMICILED FOREIGN INVESTMENTS

These investments exist in terms of South African legislation and are subject to South African regulations and laws. Rand-denominated foreign investments, as previously stated, may only be acquired via approved investment companies. On maturity, the proceeds must be repatriated, as these investments do not affect the R750 000 investment allowance available to individuals.

6.3.1 Rand hedge equities

South Africans are free to purchase rand hedge shares. Rand hedge shares are South African JSE listed shares that earn the bulk of their profits from exports. These exports are paid for in foreign currency and converted back to rands when the funds are repatriated. Profits earned by rand hedge companies would include the profits earned by their offshore subsidiaries.

The market for listed equities is governed by the Stock Exchange Control Act 1 of 1985.

Brokerage represents the major portion of costs when making a direct share investment. Local brokerage charges, after deregulation in November 1995, are fully negotiable. The sliding scale for brokerage charges that was in use prior to deregulation is still used as a guideline.

The method of fee-taking or costs is thus no longer prescribed (but must be disclosed), and varies between brokerage institutions.

According to HSBC Securities (South Africa) (Pty) Ltd, brokerage is calculated on the value of the transaction, usually subject to a minimum charge of R150 per transaction, as follows:

Table 6.1 Sliding scale of brokerage charges

Sliding scale based on the transaction values below	Rate
<R50 000	1,25%
R50 000-R100 000	1,00%
R100 000-R250 000	0,75%
>R250 000	0,65%

The aforementioned brokerage charges apply to execution only.

In the event of the service provider being called upon to provide discretionary or advisory services the costs will escalate.

According to Goodall and King (2002:743), portfolio management contracts become feasible for investment sums of R250 000 and upwards. In terms of portfolio management contracts, funds are placed under the administration of a portfolio manager. Portfolios are usually classified as discretionary or non-discretionary. A discretionary contract allows the portfolio manager to trade the portfolio at their discretion. A non-discretionary agreement usually states that the portfolio manager needs to consult with the client prior to trading the portfolio. Portfolio management costs vary and are not prescribed by legislation.

Portfolio management fees usually include a management fee of at least 1% per annum of the portfolio's value, plus a percentage of profits earned (e.g. 5% to 7,5%). In some cases an upfront percentage fee is also taken.

As already indicated, all stockbrokers work on sliding-scale fee structures with minimum fees per deal. Although trading costs vary from one broker to another, they usually represent approximately just over a third of the average equity unit trust's upfront charges.

The cost of investing a R100 000 lump sum in 10 different shares on the JSE amounts to ±R2 290. These costs, Value Added Tax included, are made up as follows:

Table 6.2 Cost of purchasing shares

Brokerage (based on a minimum of R150 per transaction)	R1 710
Bank charges	±262
Market Securities tax (0,25%)	250
Strate being an electronic settlement fee (R6 per trade)	68
	R2 290

97,7% of the original investment (R100 000) is thus available for investment after costs.

In the event of the directly purchased rand hedge equities producing a return of 10% per annum over a five year period, the after-cost return amounts to 9,49% per annum.

The aforementioned example does not accommodate the cost of a portfolio manager, neither does it include the impact of dividends received during the investment period. The impact of the relatively low costs (R2 290) on returns, is minimal.

6.3.2 Assurance funds

Most life offices (Sanlam, Old Mutual, and so on) offer endowments and retirement annuity policies that make use of rand-denominated foreign portfolios. These foreign portfolios usually consist of equities, bonds, cash and property and/or combinations of these.

According to Tony van Niekerk (2001:7), "Changes in legislation surrounding foreign investments have made foreign funds a scarce commodity in South Africa. Almost all international/global unit trusts and international funds available for individual endowments have been closed for new investments." Changes in legislation refer to the 10% of nett inflow of funds, during the previous calendar year, which was introduced in the 2001 Budget and discussed in Chapter 3.

To determine the costs of investing in a rand-denominated foreign investment, in an assurance fund, a quotation was requested from one of the big four life insurance companies in South Africa. The investment details and costs per the quotation are as follows:

Life insurance company:	Sanlam
Quotation number and date:	1163/1 and 23.12.2002
Single premium investment amount:	R100 000
Portfolio:	Offshore Balanced Fund
Term of investment:	5 years
Estimated total costs as determined from the quotation documents:	R14 724

The estimated total costs consists of marketing and administration charges (R3 000), fund management fees (R7 746), service fees of 0,5% per annum (R1 936) plus a bid/offer spread of 3% (R2 042).

Marketing and administration charge (commission) is payable according to the provisions of the Long-term Insurance Act. The intermediary comes to an agreement with the client about what percentage of the maximum commission (3%) will be charged.

Fund management fees represent the present value of a 2% per annum fee discounted at 8% per annum (the assumed inflation rate over the five year period). This fee has been calculated on a static amount of R97 000 (initial investment less marketing and administration costs).

Service fees represent the present value of 0,5% per annum discounted at 8% per annum. This fee is also calculated on a static amount of R97 000.

Bid after spread represents the present value, discounted at 8% over a five year period on a final value of R100 000.

The aforementioned quote also states the following concerning statutory charges/stockbroker fees, performance fees and termination fees:

- "Before the daily prices of the units are calculated, statutory charges and stockbroker fees will be recovered as applicable in each country in which investments are made, from assets in the investment fund(s).

- A performance fee for the asset manager will be recovered if the investment return of the investment fund is in excess of the benchmark for the investment fund. This fee is taken into account when the daily price of the units is calculated.
- The termination fee is the difference between the 'value of the investment' and the 'cash amount' quoted. The value of the investment is only available on or after the end of the initial term. The cash amount gives an indication of the amount that may be payable on cashing in the policy before the end of the initial term."

This quotation also says that the life insurance company "may change any of the charges and fees, ..., from time to time."

The terms, conditions and costs of this Sanlam quotation are very similar to those of other life companies marketing rand-denominated single premium endowment policies.

Total costs of R14 724, excluding statutory charges/stockbroker's fees, performance fees and a possible termination fee, represent 14,72% of the initial capital invested. Stated differently, only 85,28% of the original investment (R100 000) is available for investment after costs. This represents an annual cost of 2,94% over the five year period.

According to Basson (2002(a):24), "Between 3% and 9% of policyholders' assets are taken as fees annually to cover expenses and ensure a profit margin for shareholders. Basson (2002(b):22) also produced the following table in which he calculates annual charges paid by policyholders.

Table 6.3 Charges against policyholders

Rm	Old Mutual Life (SA)	Sanlam Life	Liberty ¹	Momentum ²	Sage Life
Financial year-end	12.2001	12.2001	12.2001	06.2002	03.2002
Admin expenses ³	2 804	1 914	1 073	1 421	202
Selling expenses	1 150	1 044	1 036	661	255
Tax	675	188	831	603	78
Operating profit	2 131	1 106	1 320	489	38
Total charge against policyholders (A)	6 760	4 252	4 260	3 174	573
Average policyholders' assets (B)	207 734	139 600	63 785	73 723	6 320
(A) as % of (B)	3,3%	3%	6,7%	4,3%	9,1%

(1) Charter Life excluded.

(2) Discovery Health excluded.

(3) Old Mutual and Sanlam's definition of admin expenses probably differs.

According to Basson (2002(b):22), "The accompanying table shows the amount effectively recovered from policyholders by SA's four big assurers as well as the smaller Sage Life in past financial years. Again, the figures do not necessarily reflect the experience of individuals or groups of policyholders. So, when considering corporate disclosure, it is important to remember that the figures and ratios disclosed are average figures that encompass all types of business – endowments, life policies, retirement annuities, employee benefits and so on."

A comparison of annual policyholders' costs as calculated by Basson (between 3% and 9,1% per annum) and those calculated per quotation number 1163/1 (2,94%) reveals similar costing.

In the event of this investment producing an unlikely return of 10% per annum over a five year period, the after-cost returns amounts to 6,55% per annum.

A potential investor should ask whether the aforementioned costs are reasonable and be aware of the implications of the costs as indicated above.

6.3.3 Unit Trusts

Rand-denominated unit trusts, managed by locally registered management companies, are classified into categories according to guidelines stipulated by the Association of Unit Trusts in July 1999 (Oldert, 2001(b):129). The categories for rand-denominated foreign funds are:

- worldwide funds;
- foreign funds;
- regional or single country funds.

Worldwide funds are funds that have more than 15% but less than 85% of their assets invested offshore.

According to Oldert (2001(a):8), “‘Worldwide’, however, is a peculiarly South African invention, used to classify those funds that have some money invested in SA, some overseas, but not enough in either to make them either domestic or foreign. These funds can have as little as 15% of their assets invested overseas, although most are in fact significantly invested offshore but fall short of the 85% required to be ‘foreign’ or ‘regional’. Still, one should look carefully at the portfolio structure of any ‘worldwide’ fund before paying over the money – it may not offer the offshore exposure you were hoping for.”

Foreign and regional funds must, at least, have 85% invested overseas (Oldert, 2001(b):129). These funds are popular and are an attractive investment option, but are frequently capped (closed to new investment business).

Under the aforementioned categories there will be funds that invest in equities, asset allocation funds, index funds, specialist equity funds, funds of funds, money market (or cash funds), income, bond funds, and so on.

Every unit trust fund has a trust deed. The trust deed, which each management company enters into for each fund under its control, sets out not only the relationship between the fund and various other parties but also, importantly,

states the investment philosophy and policy. This investment philosophy and policy will indicate the fund's primary objective (e.g. capital and/or income growth), as well as what type of fund it is (e.g. Foreign equity value fund or Foreign general equity fund). The investor must read the trust deed or fund mandate and understand in which country and/or asset class he or she is investing.

Aggressive marketing by the unit trust industry has convinced many investors that due to their lack of skills and time constraints, direct share investments are not a viable consideration, therefore unit trusts should rather be used.

In terms of changes approved by the Financial Services Board, which became effective on 1 April 2000, unit trusts may now apply different fees to different investors in the same fund. Some management companies now have four tiers of charges, called Class R, A, B and C.

Oldert (2002(c):11) explains the four tiers of charges as follows:

"Class R charges apply to funds in existence before June 1998, and to unit holders invested prior to 1 April 2000. The charges apply to both lump sums and debit orders. In other words, a Management Company cannot increase either initial charges or annual fees for an existing debit order client established before 1 April 2000. On reinvestment of dividends from a lump sum investment prior to 1 April 2000, the fund is also obliged to stick to the old charges (now called R Class).

Class A charges are applicable to all new investments into funds with Class A charges. Not all funds will necessarily have both Class A and Class R fees (some may just stick to their old fees), and at the time of writing, seven Management Companies have, in fact, introduced the different tiers. Class B and C charges are the fee structures that apply to institutional or other wholesale clients. Management Companies are reluctant to publish or disclose these fee structures."

According to the aforementioned source, the initial charges levied by a management company to invest in an equity based unit trust are between 6% and 7%. If one compares the purchase (buy) and repurchase (sell) prices, for equity

unit trusts as quoted in the press, the difference is usually about 6%. This difference represents the initial charges when an investment is made.

According to Oldert (2002(c):12) the repurchase (sell) price is the actual value per unit, and what the management company will pay the unit holder if he or she wants to sell these units. The purchase or buy price an investor pays is the aforementioned plus initial and compulsory charges of between 6% and 7% of the capital invested.

Besides the aforementioned initial charges annual management fees of between 1,14% and 1,92% per annum are also payable.

The total initial costs of investing a R100 000 lump sum in an equity based fund amounts to ±R6 200. The aforementioned costs for investing in a fixed interest fund amount to ±R1 150.

The make-up of the aforementioned costs plus the nett funds available for investment is clearly illustrated in Table 6.4.

Table 6.4 Initial charges and funds available for investment *after* charges and compulsory cash holdings

	Equity based funds	Fixed interest based funds
Lump sum investment	R100 000	R100 000
Less: Initial charges	±5 630	±860
Compulsory	±570	±290
	R93 800	R98 850
Less 5% compulsory cash holding	4 690	4 943
Funds available for investment	R89 110	R93 907

For equity based funds the total initial and compulsory costs amount to 6,2% of capital invested. For fixed interest based funds the initial and compulsory costs represent 1,15% of capital invested.

Stated differently, although 93,8% of the equity based funds are available for investment after the costs have been deducted, only 89,1% is actually invested in equities. The aforementioned is due to the compulsory 5% cash holding, for liquidity purposes, which all unit trusts must adhere to.

Using the fixed interest based funds, 98,8% of the funds are available for investment. Only 93,9% is, however, invested in medium to long term fixed interest investments.

In the event of these investments producing a return of 10% per annum over a five year period, the after-cost returns amount to 8,6% (for equity unit trusts) and 9,75% (for fixed interest unit trusts).

6.3.4 Tranches

These are normally, but not always, five-year endowment policies that give investors exposure to one or more offshore stock exchange indices (e.g. S&P 500 or the FTSE 100). The performance or growth of the indices is normally enhanced by a fixed percentage. Most tranches offer a capital guarantee on the capital invested nett of costs. The investment is usually structured, by using derivatives to 'gear' the investment and to provide the nett of costs capital guarantee. Tranches providing guarantees, in foreign currency terms, are scarce but available.

According to Kruger, De Kock and Roper (2001:168), "they are called tranches because the financial institution has secured capacity, e.g. R100 million, that can be invested via a single transaction."

Table 6.5 records the costs of two popular tranche products currently being marketed to the public. These costs are fairly representative of costs for similar type products.

Table 6.5 Costs of two popular tranche products

	Rand Merchant Bank offshore global guarantee product	Cadiz Euro-Top lock in product
Initial investment	R100 000	R100 000
Investment term	5 years	5½ years
Initial charges (VAT inclusive)	R6 840	R5 700
Annual management fee	R0	R0
Funds available for investment	R93 160	R94 300

In the event of the aforementioned tranches producing a return of 10% per annum over a five year period, the after-cost returns amount to 8,45% (for Rand Merchant Bank product) and to 8,72% (for the Cadiz product).

6.3.5 Costs and transparency

In sections 6.3.1 to 6.3.4 the costs of investing R100 000 in various rand-denominated offshore investments were identified. The difference in costs of investing the aforementioned amount in rand hedge shares (R2 290), and investing in a single premium endowment policy (R14 724), is substantial.

The aforementioned two investments are, however, vastly different and cater for very different types of investors. A sophisticated hands-on investor understanding equities, markets, risk return relationships and diversification, etc. could, and most probably should, invest in good quality rand hedged equities. For the less sophisticated investor, rand-denominated foreign unit trusts, tranches and even endowment policies could be considered.

It has already been mentioned and illustrated that the initial front-end loaded fees and other costs reduce the capital that is invested. Table 6.6 provides estimated cumulative break-even returns of the various rand-denominated investments discussed.

Table 6.6 Cumulative break-even returns for the various rand-denominated investments discussed

	Cumulative break-even return
Direct investment in rand hedge equities	2,34%
Assurance funds	17,27%
Equity based unit trusts	6,61%
Fixed interest based unit trusts	1,16%
Tranches	6,69%

Cumulative break-even returns illustrate the return that the invested capital after-costs must achieve to recover (or break-even) the initial capital (before costs) invested.

Investors should be cognisant of the following:

- Initial costs are a direct expense against capital invested. The effect of higher initial upfront costs are that higher break-even returns are required to enable the investor to regain capital forfeited as a result of the front-end loaded initial costs.
- All costs are a direct penalty on investment performance.

The impact of a 1% per annum difference in costs over a 20 year period has the resultant effect of a 20% reduction of capital at the end of the mentioned period.

Costs, which are not always transparent, should be determined and understood. There is certainly no point in paying higher costs without justification.

6.3.6 Advantages and disadvantages

Important advantages of investing in rand-denominated foreign investments would include:

- currency hedging; and
- low entry levels (premiums or contributions).

Currency hedging entails enhanced investment performance via rand depreciation. In the event of rand appreciation the converse would be true. Rand-denominated investments are available via relatively low monthly contributions (premiums). Investors could access endowment policies, using foreign portfolios, with a low monthly premium of R500.

Principal disadvantages would include:

- Investment proceeds must be repatriated;
- Costs are loaded. Usually there is a double layer of management costs because a local product provider as well as a foreign fund manager is involved. The lack of supply factors also contributes to additional costs.
- Capping of funds. It has already been mentioned that changes to the asset swap legislation have made rand-denominated foreign funds a scarce commodity. When authorised institutions (long term insurers, pension funds, fund managers and unit trusts) reach their asset swap limits, legislation compels them to close (or cap) these funds. Many of these funds have been compelled to dilute offshore exposure due to the asset swap rules that come into force when they experience a reduction in local assets under management.

6.4 FOREIGN-BASED OFFSHORE INVESTMENTS

These are investments into any foreign-based offshore asset or funds. Therefore the R750 000 offshore investment allowance is utilised and SARS and SARB approval is required. The aforementioned assets may be redeemed and the proceeds need not be repatriated.

The foreign-based investments discussed in this section are domiciled overseas. They are created in terms of legislation governing the jurisdiction from which they operate, and they are subject to the regulations of that jurisdiction. In terms of the foreign investment allowance, South African investors may invest in any foreign asset or fund. According to Kruger, De Kock and Roper (2001:170) there are an estimated 40 000 unit trusts and mutual funds around the world.

6.4.1 Financial Services Board approved investments

If a South African investor chooses to invest offshore, it is recommended that they use Financial Services Board (FSB) approved products. FSB approved products are those registered with the FSB, a South African regulatory authority set up in terms of the Financial Services Board Act (97 of 1990).

According to Oldert (2001(a):7), "in terms of FSB regulations, funds that wish to actively sell and market themselves in South Africa must first register with the FSB. In terms of this registration, the FSB tries to ensure that any funds actively sold here are solvent and reputable, properly represented, and that salient details will be communicated to prospective investors – especially where these differ from South African norms." South Africans thus may invest with whomever they want, but by investing with an FSB approved fund they are afforded the peace of mind of knowing that the approved funds have been 'checked out' and cleared by the FSB, and that they have proper representation in South Africa.

The list of FSB approved funds changes and is updated regularly. A list of these funds is available from the FSB on their website, www.fsb.co.za.

6.4.2 Equities and bonds

An experienced and competent investor could obviously purchase equities or bonds from any foreign stock exchange. Due to the relative value of the rand compared to the major currencies in the world, this option is usually only recommended for experienced competent investors with at least R1 million available for investment. The million is usually achieved by 'pooling' a married couple's investment allowances.

In recent years, discounted brokerage services have become increasingly available. A schedule of commissions, transactions and handling fees obtained from one of the prominent discount brokers, which is fairly representative of the industry, reveal the following costs:

- Shares traded via an automated telephone and/or telebroker will be charged at \$0,03 per share with an overriding minimum of \$49,95.
- Broker-assisted trades carry an overriding minimum of \$54,95 per trade. The size of the fee is subject to the size of the transaction, as indicated in Table 6.7.

Table 6.7 Costs of foreign broker-assisted equity trading

Transaction size	Commission rate
\$0 - \$2 499	\$35 + 1,7%
\$2 500 - \$6 249	\$65 + 0,66%
\$6 250 - \$19 999	\$85 + 0,34%
\$20 000 - \$49 999	\$115 + 0,22%
\$50 000	\$170 + 0,11%
\$500 000	\$270 + 0,09%

Or the following minimums and maximums, which apply to broker-assisted trades for stocks share:

- For the first 1 000 shares, the greater of the overriding minimum of \$54,95 or \$0,09 per share.
- For shares over the first 1 000:
 - For stocks that are at least \$1 per share, but less than \$5 per share, an additional \$0,04 shares above 1 000 applies.
 - For stocks \$5 per share or higher, an additional \$0,05 per share for shares above 1 000.
- Maximum charge per trade is \$80 for the first 100 shares, plus \$0,55 per share thereafter.

Estimated cost of investing a R100 000 lump sum in five different shares listed on the New York Stock Exchange (USA) would amount to ±\$102,31 or R897.

Although the aforementioned costs are relatively low, a South African investor would find it difficult, due to prices of good quality USA equities, to acquire a diversified portfolio of quality equities for R100 000.

Offshore equity brokerage costs of R897 on R100 000 investment is also less costly than the brokerage (R2 290) of their South African counterparts.

Private companies in Cape Town provide portfolio management services for institutions and private investors wanting to acquire foreign equities and bonds. The minimum lump sum they are prepared to accept is R250 000 and their fees vary as follows:

- Initial fee of between 2,28% and 4,25% of capital invested; plus
- Annual fee of between 2% and 2,4%.

A South African investor wanting to access foreign fixed interest investments may acquire them by purchasing same from a foreign-based brokerage/security company. South African brokerage companies do not sell foreign fixed interest investments.

A United Kingdom based brokerage/securities company indicated that the brokerage costs of purchasing fixed interest investments would be as follows:

Table 6.8 Costs of purchasing a foreign fixed interest instrument

Pound value of fixed interest instrument	Brokerage as a % of the purchase
On the first £20 000	1%
On the first £20 000–£80 000	0,5%

An administrative fee of £30 is also charged.

The estimated total cost of purchasing the aforementioned fixed internal instrument is ±R1 421.

6.4.3 Assurance funds

As with local endowment policies, offshore endowments are also available. Recurring premium endowment and retirement annuities have recently also become available. The investor or the insurance company is compelled to obtain clearance from the SARS and the SARB. Various investment portfolios are available.

Sanlam has, for instance, formed a company that has an insurance licence in Jersey. This company handles most of the administrative work. And once SARS and SARB clearance has been obtained, the investor may commence contributing a minimum premium of R750 per month. On maturity the policy proceeds will be receivable in a foreign currency and in a country of the investor's choice.

Major South African life companies, as well as foreign life companies, offer these expensive and popular products.

Any foreign life insurance company wanting to conduct business in South Africa is required to register a company in the Republic and also needs to acquire approval from the Financial Services Board (FSB).

According to Ms S. Vogelsang from FSB, only two foreign life insurance companies that market products to the general public have adhered to the aforementioned requirements.

As far as the writer is aware, both these companies (AIG Life SA Ltd, and Pinn African Life Ltd) do not market endowment-type policies to the general South African public.

Accordingly, in the event of an investor wanting to use this rather expensive method of investing offshore, he or she may either:

- use a South African life assurance company that transfers the client's funds offshore and purchases foreign assets. All premiums paid and transferred

offshore need SARS and SARB approval. As the R750 000 investment allowance is utilised the funds do not have to be repatriated.

- after acquiring the necessary approval, transfer the funds offshore and invest in any foreign-based (non-FSB approved) life assurance product.

As previously stated, it is recommended that one deal only with FSB approved institutions.

The costs of investing in a five year single premium endowment policy, with a South African life company placing the funds offshore, have been dealt with comprehensively in section 6.3.2.

6.4.4 Mutual funds

Mutual funds are comparable with South African unit trusts. Various types of mutual funds, e.g. closed and open ended funds, are available. These funds are usually classified as general or specialist funds and their mandate will inform the investor regarding their investment policy (type of asset class and regions and/or countries).

Mutual funds usually trade using a company structure unlike unit trusts, which make use of a trust structure.

It is worth repeating that it is recommended that South African investors only invest in FSB approved mutual funds.

An individual investor choosing a mutual fund should consider not only the fund's stated investment policy and past performance, but also its management fees and other expenses.

According to Bodie (2001:107), "Competitive data on virtually all important aspects of mutual funds are available in the annual reports prepared by Wiesenbergs Investment Companies Services or in Morningstar's Mutual Fund Sourcebook."

Some mutual funds operate as roll-up funds. A roll-up fund is a fund, unlike South African unit trusts, that does not distribute any income (dividends or interest). In a roll-up fund the management company does not distinguish income from capital. Income received by the fund would increase the capital value of each unit holder's investment.

Because offshore funds have been unregulated there is no set formula for charges. Accordingly, some funds have no initial charges (front-end loaded charges), but then have high annual charges. Others have low initial charges but high exit fees if exited after a short period. Some have no fixed charges, but high performance fees. Many also have 'hidden' costs; costs that are not transparent. Any combination of the aforementioned methods of charging is used.

When commenting on costs, overseas literature often refers to a Total Expense Ratio (TER). According to Oldert (2002(a):13), "The Total Expense Ratio is an attempt to deal with the tremendous variation in charging structures overseas." He goes on to say that, "Typically, TER makes a set of fixed assumptions about the amount to be invested, the period of the investment, and so on. Then all charged levies by the fund (including annual charges against the asset value) are added together and expenses as a percentage of the total amount invested. On this basis, you have an objective and fair way of comparing the cost to the investor."

He also says that there are many definitions of TER and that the potential investor should read and understand same.

Offshore funds are governed by different rules and regulations that do not always require full disclosure of all costs. Accordingly, it would be prudent to request a signed letter from the mutual fund company detailing all costs that will be incurred.

According to James Anderson, as quoted by Oldert (2002(a):14), "There are three elements that make up what is called the Total Expense Ratio (TER): the annual management fee; administrative costs, such as transaction charges; and other

operating costs. Typically, it is only the annual management fee that is quoted in mutual-fund literature.” He goes on to say, “TERs show enormous variation from one fund to another. In the equity fund category, for example, TERs vary from the cheapest, at 0,14% (Standard Life Trust Management), up to more than 29 times this, at 4,03% (Rothschild Asset Management). Over five years, these costs represent over 20% in lost returns.”

The costs of the first comprehensive range of offshore index tracker funds, launched and approved by the Financial Services Board, are as follows:

- Equity based index tracker funds: Initial charge of 5% of the investment and an annual service fee of 1,5%.
- Global bond index fund: Initial charge of 2% of the investment and an annual service fee of 1%.

Considering that index funds are passive investments, these costs seem high. A quick comparison of the fees (or costs) of FSB approved foreign-based funds with non-FSB approved foreign-based funds does seem to indicate that the first mentioned costs are higher. Perhaps this is due to the lack of transparency.

6.4.5 Standard and Poor's Depository Receipts, American Depository Receipts and World Equity Benchmark Shares

Standard and Poor's Depository Receipts (SPDR or spider) is an investment vehicle that simulates the Standard and Poor's Composite 500 stock index (S&P 500). SPDR is very similar to WEBS, as discussed in the following paragraphs.

Investment instruments that may also be used for investing in non-United States securities are American Depository Receipts (ADRs) and/or World Equity Benchmark Shares (WEBS).

SPDR, ADRs and WEBS are indirect ways to own offshore equities.

According to Bodie (2001:646) and Kreitler (2000:122), ADRs give the investor an investment in just one non-United States based company. In the event of an investor wanting to purchase 10 different non-United States based equities via ADRs, he or she would need to purchase 10 different ADRs, each representing a specific company's equity.

ADRs are thus available only for major non-US companies and are traded only in the United States and not in other markets. An investor using ADRs to invest globally does not have access to all non-US equities or markets.

Although ADRs are less expensive than mutual fund companies, the last mentioned are usually preferred by offshore investors because they hold diversified portfolios consisting of various equities from different world markets.

According to Kreitler (2000:123), "WEBS are investment vehicles designed to simulate buying an entire country stock market index. There are 17 of these WEBS, which are traded like a stock on the American Stock Exchange. Each is designed to perform like the MSCI index for that country."

An investor interested in the Swiss market could buy a WEBS from Switzerland. A WEBS is similar to a SPDR, or spider.

Bodie (2001:646) states that WEBS or foreign index baskets are available for Australia, Austria, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Malaysia, Mexico, Netherlands, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

According to Bodie (2001:646), "WEBS shares offer US investors portfolio exposure to country-specific equity markets, in a single, listed security that you can easily buy, sell or short on the Amex. Amex being the American Stock Exchange."

Generally WEBS appear to be more popular than ADRs because, while ADRs provide you with an investment in just one company, WEBS enable the investor to gain exposure to a broad portfolio of a desired foreign country's equities.

According to aforementioned source, the investor pays commission on the purchase and sale of WEBS, but since their portfolios are passively managed, their management and administration fees are relatively low and they eliminate most of the transaction charges typical of managed mutual funds.

6.4.6 Property

The purchase of properties in the major cities of the world is becoming popular amongst South Africans. Local as well as offshore companies have products available where the underlying assets that are invested in are international real estate. These funds are comparable to mutual funds, the major difference being that the underlying assets are real estate and not, for instance, equities or bonds.

The costs of investing in property via mutual funds would be similar to those discussed in section 6.4.4.

6.4.7 Tank containers

Tank containers are an anomaly. According to Kruger, De Kock and Roper (2001:171) they are not a rand-denominated investment product and SARS clearance is not required to purchase a container.

Income earned offshore, from containers, may now be legally kept in an offshore account (Goodall, 2001:Part 2, section 14.3). A tank container is a large high-quality stainless steel drum specifically designed to carry foods, preservatives and so on.

Containers are rand hedge investments. Investment into tank containers does, however, incur a number of costs. These costs need to be understood and examined prior to any investment being made.

After perusal of marketing literature, it appears that lease managers' fees and other management fees amount to 22,5% of annual gross lease income earned by these containers.

One of the greatest attractions, besides the foreign currency income, is the wear and tear tax allowance (on the cost of the container) that can be claimed as a tax deduction. Recoupments on sale, however, will obviously be taxable.

This investment is extremely tax efficient and is a useful tool for long- and short-term retirement planning.

6.4.8 Foreign currency bank accounts

Presently it is possible to invest in a foreign currency via a local or foreign bank. After receiving SARS and SARB authorisation, a South African investor can approach his or her local bank and request them to convert rands to, for instance, USD and place these funds in a call account. The interest rate earned on these accounts would be similar to that earned by a foreigner on his or her USD call account. Foreign interest rates are relatively low by South African standards. These investors would obviously reap the benefits of any local currency depreciation.

The costs of these bank accounts vary. One of the major South African banks charge 0,35% of the rand amount deposited, with a minimum fee of R42 and a maximum fee of R270 per transaction. A fee of R50 is also charged when funds are withdrawn from this account.

6.4.9 Hedge funds

According to Reilly and Brown (2000:943), “the goal of a hedge transaction is to create a position that, once added to an investor’s portfolio, will offset the price risk of another, more fundamental holding.” It could be said that hedge transactions attempt to neutralise investment risk. This is usually achieved by derivative instruments like futures, forward contracts and/or options.

These are fairly specialised products that should only be used by investors once they understand the risk and the functioning of these derivatives and funds.

Prior to the signing of The Collective Investment Schemes Control Act, during December 2002, South African investors could only access FSB approved hedge funds via life assurance policies. The onerous costs investing via life assurance policies has already been discussed in section 6.4.3.

The Collective Investment Schemes Control Act, which replaces the Unit Trust Control Act and the Participation Bond Act, will come into effect on 1 March 2003 and paves the way for the introduction of new investment vehicles. Hedge funds will surely be one of these new vehicles. According to Temkin (2002:2), the Collective Investment Schemes Control Act will enforce disclosure of costs, the investment aims of the scheme, method of calculation of the nett asset value, dealing prices, etc.

It will be interesting to see what the investment minimums and charges will be once FSB approved, non life assurance wrapped offshore hedge funds become available to the South African investor.

Although investing in a hedge fund seems to be the fashion statement of the season, the following factors need contemplation before investing in a non-FSB approved hedge fund:

- The lack of transparency makes proper analysis of strategy and costs problematic.

- The lack of regulation forces any potential investor to do a laborious due diligence, prior to investing.
- High investment minimums usually make these investments unaffordable for most South African investors. It is not uncommon for USA based funds to have investment minimums of \$100 000.
- Hedge funds seem to reduce market risk but increase management risk.

The *caveat emptor* principle, meaning let the buyer beware, seems especially appropriate to hedge funds.

6.4.10 Options and warrants

According to Van den Berg (1998:78), “the holder or owner of an option has the right, but does not have an obligation, to buy or sell an underlying instrument at a predetermined price during a specific period or at a specific time.”

There are two basic types of options, namely:

- a call option; and
- a put option.

A call option gives the holder thereof the option (but not the obligation) to purchase an underlying investment instrument. A put option grants the holder thereof the option (but not the obligation) to sell an underlying investment instrument (usually shares, bonds, and so on).

According to Van den Berg (1998:86), “Warrants are long-dated call or put options written by certain banks.” They are also fairly specialised products that should only be used by investors once they understand the risk and the functioning thereof.

6.4.11 Cost and cumulative break-even returns

Cost makes a significant impact on the total nett return generated from an investment.

Table 6.9 provides estimated cumulated break-even returns of some of the various foreign-based offshore investments.

Table 6.9 Break-even returns for various foreign-based offshore investments

	Cumulative break-even return
Direct investment in equities	0,009%
Direct investment in fixed interest investments	0,014%
Assurance funds	17,27%
Mutual funds – equity based funds	4,2%
Mutual funds – fixed interest based funds	2,04%
Property	4,2%

The aforementioned table clearly illustrates the increase in the cumulative break-even return required when making use of structured investment products (assurance funds, mutual funds, etc.).

Although costs can have a big impact on nett investment performance, it is at times difficult to determine the exact cost or expenses accurately. This problem arises mostly due to the following:

- Lack of transparency.
- The common practice of paying for some expenses via kickbacks received by, for instance, assurance on mutual fund managers. These kickbacks are usually received from stockbrokers for directing the fund's trades to that particular broker. The kickbacks are often used to pay for the research and development.

It is not feasible to determine the exact cost or fee structure of all the offshore products mentioned due to factors already mentioned in previous paragraphs.

Costs are dynamic and vary in accordance with capital invested and also, but not least, the negotiating skills of the potential investor.

Investors should, however, determine and understand all costs involved prior to making any investment, because the impact of costs is reflected in investment performance.

6.4.12 Advantages and disadvantages

Important advantages of investing in foreign-based offshore investments would include:

- currency hedging;
- hedging of political risk;
- relatively low costs;
- currency choice; and
- freedom from exchange charges on maturity or liquidation of the investment – no repatriation of funds required.

Currency hedging has already been discussed.

Foreign investments should be made in a more stable country, thus reducing the investor's country and/or political risk.

Direct foreign-based offshore investments' total costs are usually less than rand-denominated foreign investments. There is no double layer of management costs or a limited supply of these investments.

Currency choice involves the investor making a decision regarding which currency he or she wishes to use. Preferably hard currencies like the USD or euro should be used.

On maturity of the investment or if the investment is liquidated, there is no need to repatriate the funds.

Disadvantages would include:

- investments require high entry levels. These investments are denominated in strong currencies and entry levels (minimum investment amounts) may be high in rand terms;
- income tax and estate planning could become problematic; and
- transparency of costs.

6.5 INTERNATIONAL INVESTMENT STRATEGIES AND INVESTMENT MANAGERS

It is indeed a very daunting task to comment on possible investment strategies. This task is amplified by the fact that each investor's risk tolerance, as well as their personal circumstances and objectives usually differ vastly. This section will briefly identify broad international investment strategies, discuss various investment styles (passive and active investing) and comment on investment managers.

6.5.1 International investment strategies

As discussed in Chapter 5, the primary objective of investing offshore (or in foreign markets) is to diversify a portfolio. These investments will also provide protection against currency (rand) depreciation. The expected risk reduction and enhanced returns may, however, not be achieved if the funds are invested for too short a period and/or the incorrect asset allocations (or asset class mix) are used.

Offshore investments should contribute or enhance existing local investments (assets) as well as their risks, returns and liquidity. Depending on the age and risk tolerance of the investor, the assets and/or investments should consist of at least cash, bonds, equities and property.

South Africans should ideally invest in developed and/or other developed markets (section 5.3) with a low or negative correlation to South Africa's mature emerging

market. Variations in global historical rates of returns, correlations and standard deviations, as discussed in section 5.4.2.2, should be used to construct well balanced (various asset classes) diversified portfolios. According to empirical evidence, as discussed in sections 5.2.1.8 and 5.2.2.3, as well as information provided in section 5.4.2.2, global equity markets have significantly outperformed the South African market (on a risk adjusted basis) over the last 10 year period.

It is also interesting to note the very high risk premium (11,9%) applicable to South African equity investments as calculated in Table 5.18.

Table 5.16, which measured various countries' equity indices converted back to rands (thus taking into account rand depreciation), makes for particularly interesting reading. Table 5.17 amplifies the aforementioned results and highlights the disservice done to South African investors via exchange control rules and regulations.

Will these results be similar in the future? Who knows? However, considering the specific risk factors affecting and applicable to corporate South Africa and therefore securities (discussed in section 5.2.1), plus the wise words of Santayana, "Those who do not remember the past are condemned to repeat it", it would be foolhardy not to make use of the great risk reduction benefits of offshore diversification.

6.5.2 Portfolio management styles

According to Reilly and Brown (2000:902), "Equity portfolio management styles fall into either a passive or an active category." They go on to say that "unlike the immunization of bond portfolios, no middle ground exists between active and passive equity management strategies."

6.5.2.1 Passive equity style investing

Reilly and Brown (2000:902) say, "Passive equity portfolio management is a long-term buy-and-hold strategy. Usually stocks (shares) are purchased so that the portfolio return will track those of an index over time. Because of the goal of tracking an index, this approach is generally referred to as indexing." The purpose of a passive or indexed portfolio is not to 'beat' their target index, but to match its performance. According to the same source, "A manager of an equity index portfolio is judged on how well he or she tracks the target index – that is, minimizes the deviation between portfolio and index returns (i.e. tracking error)."

When an investor has to make a decision regarding which investment style to pursue (or combination of investment styles), the following factors need to be contemplated:

- the lower costs but less exciting alternative of indexing; or
- the higher costs but potentially more lucrative alternative of active management.

According to Reilly and Brown (2000:902), "The critical factor in this evaluation is the stock picking skill of the portfolio manager, if an active investment style is pursued." They, however, conclude by saying that, "Some indexing is appropriate for funds in most risk objective classes."

When researchers and/or academia analyse and discuss local investment performances (discussed in sections 5.2.1.8 and 5.4.2.1), they tend to use indices, like the JSE all share indices, as a benchmark for passive equity investment. This could suggest that a world market index might be useful for a passive international strategy. However, the main reason for investing offshore is not to replicate the global market or to enhance returns. The main reason is to reduce risk or, stated differently, the volatility of returns. All foreign shares don't move in sync with the South African share market. Other markets may be 'performing' while the South African market is 'not performing'. The South African passive investor thus needs to invest in markets that are uncorrelated to the South African market. Although risk, returns and correlations of international shares and bonds information is

provided in Table 5.7, potential investors should bear in mind that this is historical data and correlations are not static.

Due to many factors, which would include major specific risks associated with South African markets and securities (discussed in section 5.2.1), rand depreciation and the size of the South African market, passive style investing in developed and/or other developed offshore market indices would most definitely reduce risk for a South African investor.

Indices that could be considered include the Dow Jones Industrial Average (DJIA) consisting of the 30 largest, 'blue-chip' corporations in America. America, as already indicated, is the largest developed market in the world.

According to Bodie, Kane and Marcus (2001:48), "The Standard and Poor's Composite 500 (S&P 500) stock index represents an improvement over the DJIA in two ways. Firstly, it is a more broadly based index of 500 companies. Secondly, it is a market value-weighted index." The same source states that, "A market value-weighted index is computed by calculating a weighted average of the returns of each security in the index, with weights proportional to outstanding market value."

The New York Stock Exchange (NYSE) publishes a market value-weighted composite index of all NYSE-listed stocks, in addition to sub-indices for industrial, utility, transportation, and financial stocks. These indices are more broadly based than the S&P 500 (Bodie, Kane and Marcus, 2001:50).

The ultimate US equity index is the Wilshire 5000 Index of the market value of all NYSE and American Stock Exchange (Amex) shares plus actively traded Nasdaq shares.

Vanguard offers unit trusts (or mutual funds) to small investors (with limited funds) that enable them to match the performance of the Wilshire 5000 Index, the S&P 500, or the Russell 2000 index of small firms.

Other well known indices include the Nikkei, FTSE and the Dax.

According to Bodie, Kane and Marcus (2001:51), "The Nikkei 225 is a price-weighted average of the largest Tokyo Stock Exchange stocks. The Nikkei 300 is a value-weighted index. FTSE is published by the *Financial Times* of London and is a value-weighted index of 100 of the largest London Exchange corporations. The Dax index is the premier German stock index."

Recently market value-weighted indices of non-American shares have been computed by Morgan Stanley Capital International (MSCI).

New funds, called WEBS, an acronym for World Equity Benchmark Shares, that track foreign markets have also been launched. These are low-cost foreign index funds that eliminate some of the guesswork and cost of investing offshore. WEBS are not mutual funds and offer another avenue to pursue when considering a passive investment style of investing.

If the potential South African offshore investor is a propounder of the efficient market theory (discussed in Chapter 4), then he or she could make use of the passive equity investment style. Because of America's hegemony over the free-world economy, at least one of the aforementioned American indices would be utilised in a diversified passive style portfolio.

6.5.2.2 Active equity style investing

According to Reilly and Brown (2000:902), "Active equity portfolio management is an attempt, by the portfolio manager, to outperform, on a risk-adjusted basis, a passive benchmark portfolio. A benchmark portfolio is a passive portfolio whose average characteristics match the risk-return objectives of the client."

If the efficient market hypothesis was taken to the extreme, there would be no advantage in pursuing the active equity style of investing. Most developed or

other developed financial markets are more probably near-efficient. Profit opportunities may thus exist for diligent and creative active equity style investing.

Being an active equity style manager is not an easy task. Active style managers must overcome at least two difficulties, namely:

- by the very nature of their investment style they will incur higher transaction costs than a passive style investor manager would. If transaction costs plus fees (active manager's fees) total 1,5% (annually) of portfolios' assets under management, then active managed portfolios have to earn a return of 1,5 percentage points above the passive benchmark, just to keep pace with it;
- because the active manager takes certain views on the market and manages the portfolio accordingly, these active portfolios usually have a higher risk than the passive benchmark.

Active managers usually use three generic themes to time the market and add value to their portfolios, namely:

- they use asset allocation or asset mix. They can try to time the equity market by shifting funds into and out of shares, bonds and cash. The shifting of funds would depend on market forecasts, risk premiums, and so on;
- they can shift funds among different equity sectors and industries (financial shares, consumer shares, resources, and so on) or among investment styles (large capitalisation, small capitalisation, value, growth, and so on) to enable them to find winners before the rest of the market does; and
- they could do share-picking by doing analyses (using fundamental and technical analyses as well as the principles of model portfolio theory) in an attempt to find undervalued shares, i.e. buy low and sell high.

Condon (1983), as cited in Rosenberg (1991:25), considers 'asset mix' the single most important determinant of performance. He goes on to say that although most equity managers focus on stock selection, specific stocks held will not have nearly as much impact on total performance as will the overall level of equity commitment. Rosenberg continues by saying, "In setting asset mix, one ought to take into account the following inputs:

- the investor's objectives, constraints and preferences and the investment strategies appropriate to those circumstances;
- forecasts of return and risk of each asset class and estimates of the correlation among asset class return patterns."

Rosenberg (1991:25) then says that, "Ellis (1985:33) confirms that the single most important dimension of investment policy is asset mix, particularly the ratio of fixed income investments to equity investments."

From the aforementioned it is clear that asset mix (or asset allocation) is fundamental to investment performance (or risk adjusted returns). Rosenberg also expresses concern about the lack of difference between the asset allocations of investors with very different time horizons and investment objectives.

Asset allocation is thus of vital importance. The asset allocation process requires not only estimates of correlations between asset classes, expected returns and the expected standard deviation of those returns, but also the estimation of risk of those parameters.

Research conducted by Barr and Affleck-Graves (1987:95-113) on diversification into foreign assets, concluded by saying that, "We have shown that although a foreign deposit account will hedge an investor's foreign exchange position, an international portfolio should generally be weighted towards equity investments. An equity investment will provide the foreign exchange hedge as well as additional diversification into foreign assets. The stronger the relationship between the return on an equity market and the exchange rate the less the hedging potential of a deposit becomes *vis-à-vis* an equity investment."

According to William Meyer (2001:2), treasurer of the Shareholders' Association and chief executive officer of Fenestra Asset Management, "Sir John Templeton has much to teach us. A pioneer in his day of cross national investing, he brought home the advantages this has in terms of reducing volatility and increasing returns. Never before has it been more important to have a properly structured

and internationally diversified portfolio.” He goes on to say that, “It takes patience, discipline and courage to follow the contrarian route to investment success; to buy when others are despondently selling, or to sell when others are avidly buying. However, based on half a century of experience, I can attest to the rewards at the end of the journey.” Meyer also believes that:

- if you search throughout the world you will find bigger and more bargains than locally; and
- investors should never permanently adopt a type of asset or selection method.

Contrary to Templeton’s approach, Warren E. Buffet believes that diversification is an excuse for ignorance. Buffet is perhaps most famous for his articulation of the concept of franchise investing. By this is meant buying shares that have some sort of monopoly. A favourite example of this is Coca Cola, which has the strongest franchise in the world (Meyer, 2001:2).

According to Bradfield (2001:4) (who is head of quantitative research at Cadiz Holdings and part time professor at the University of Cape Town), “Internationally, the success rate in trying to forecast company earnings is abysmal.” Bradfield’s research indicates that most fund managers have a poor record in timing share purchases. He goes on to say, “There are just two ways a fund manager can add value: through stock selection and timing. A fund manager can reduce stock selection risk by buying a wider spread of stocks. But when it comes to timing, you either get it right or wrong. Prices only move up or down. We say fund managers shouldn’t try to time the market. Fund managers should not take risks at all. They should reduce their tracking error to zero by choosing a benchmark based on the mean performances of their peers.” This sounds like passive investment, but it is not. Bradfield advocates ‘enhanced passive’ investment. This is achieved by placing the core of the portfolio in a passive investment linked to an appropriate benchmark, and the balance in an actively managed satellite portfolio designed to spice performance. According to Bradfield, a conservative fund should be 85% invested in the core and 15% in the satellite portfolio. An aggressive fund should increase the satellite weighting to about 40% (Bradfield, 2001:4).

David Weil (2001:13), managing director of Alexander Forbes' Investment Education Services, says, "Funds can elect to have a balanced approach, combining both active and passive. A fund can demand local returns above the market but be content with market-related international returns. However the prudence of such a decision is debatable."

There are many conflicting ideas and thinking regarding passive and active equity style investing. However, each investor, subject to his knowledge of investments, risk and return objectives and personal circumstances, will have to make an informed choice.

6.5.2.3 Passive and active bond style investing

According to Reilly and Brown (2000:622), "there are basically four major bond strategies: passive strategies, active strategies, matched-funding techniques and structured active management."

According to the aforementioned source, two specific passive strategies exist. First is the buy-and-hold strategy in which a manager selects a portfolio of bonds based on the objectives of the client with the intent of holding these bonds to maturity. Using the second passive strategy – indexing – the objective is to construct a portfolio of bonds that will equal the performance of a specified bond index.

According to Reilly and Brown (2000:624), five active strategies are available. They are interest rate anticipation (which involves economic forecasting), valuation analysis and credit analysis (which require detailed bond and company analysis). Alternatively, yield spread analysis and bond swaps, which require economic and market analysis, are also available.

The five active strategies will not be discussed because they fall beyond the ambit of this assignment. Suffice to say that investors should at least understand the following:

- The inverse relationship that exists between the rise in market interest rates and the reduction in the capital value of the bond or gilt.
- The bond strategy used should be based on the needs and/or objectives of the investor.
- According to Reilly and Brown (2000:661), “the risk-return performance of bonds as a unique asset class has been consistent with expectations. In addition, their inclusion has generally enhanced overall portfolio performance because of their low covariance with other financial assets.”
- According to the aforementioned source, “studies in the bond market have supported the theory of weak-form efficiency.”
- South Africans wanting to invest in offshore bonds have to consider the relatively low interest rates (relative to South Africa’s much higher rates) available in developed markets as well as the risk reduction that the aforementioned markets provide. The benefits of rand depreciation also need to be considered.
- Statements made regarding asset allocation (see section 6.5.2.2) plus data presented in Tables 5.11, 5.15 and 5.17 should be considered.

6.5.3 Investment managers

Once the investor has considered the aforementioned information and has decided to invest offshore, he or she needs to decide on an investment or fund manager. Some fund managers like Peter Lynch, Warren Buffet and so on, have achieved celebrity status.

There are fund managers who flourish and prove their skills in particular market conditions. However, when a particular stage of the economic cycle is over, they seem unable to replicate their success.

Should a single fund manager, a fund of fund approach, or a multi-manager be used? The following discussion presupposes that the offshore investor, due to the relatively small amount of foreign currency available via the investment allowance, will make use of unit trusts or mutual funds as an investment vehicle for his or her offshore investments.

6.5.3.1 Single fund managers

The term single fund manager is a misnomer. Fund managers seldom work alone. Although they may have to take final responsibility for which security to purchase, when to purchase and at what price, they are usually supported by teams of researchers and analysts. According to Anthony Katakuzinos (managing director of Standard Bank Unit Trusts), cited in Oldert (2001(b):65), "Where one fund manager has responsibility for a fund, he (or she) usually has instant access to every detail of the portfolio and is able to react very quickly to market information. With a single-manager fund, the manager focuses exclusively on that portfolio and is aware of the underlying investments and all the investment decisions that have been made. These fund managers can adjust their portfolios immediately in the face of changing market conditions." He goes on to say that, "essentially, there are two types of managers of single-manager funds – those who follow a 'house-view', and autonomous managers who have earned their reputations through their past performance and are given freedom to follow their instincts. I would expect single manager funds to be the top performing funds in their categories."

Costs and/or fees associated with these funds vary and need to be determined prior to investing.

6.5.3.2 Fund of fund managers

According to Andrew Denny (product development manager at Old Mutual), cited in Oldert (2001(b):67), "The basic investment theory behind Fund of Fund (FOFs) is that stock picking does not hold nearly as much value as asset allocation. In other words, being in the right sector is the most important investment decision. In

a fund of funds, the experts make the asset allocation decisions, and while there is no guarantee that they will get it right all the time, they will have a better chance than most advisors or investors.” He also says “that assuming you know the correct asset allocation to suit your risk profile, how does the investor choose between the various general equity funds or the financial funds or any number of other unit trusts available to the investor?”

FOFs thus seek to add performance by combining the asset allocations, sector strengths and different fund managers’ skills in one fund. An ‘overall’ fund manager chooses different combinations of funds according to the risk profile of the investors. FOFs provide a very effective way of obtaining exposure to international markets.

The costs and fees associated with these funds also vary as another layer of management costs have been added. Investors must determine costs prior to investing.

6.5.3.3 Multi-managers

According to Paul Stewart (managing director of m Cubed Capital), cited in Oldert (2001(b):69), “multi-managers presupposes that instead of relying on the abilities of a single fund manager whose performance may be variable, multi-managers select a broad range of specialist fund managers to manage different portions of a portfolio on the investor’s behalf. The main objective of multi-manager management is to address perhaps the biggest challenge facing investors today, namely, which asset classes and sectors should they be investing in, and following on from that question, which specialist fund manager should then be selected to manage these speculative portfolios. Multi-managers are therefore responsible for the hiring and firing of these managers based upon their quantitative and qualitative responses. Furthermore, the multi-manager is involved in agreeing terms upon which asset managers will manage specialist portfolios, such as setting mandates, ensuring compliance with the mandates, and then finally

blending these specialist portfolios together into a sensible and controlled arrangement.”

According to Leon Kaplan (executive director of Investments and Finance for Sage), cited in Lambrechts (2001:10), “The multi-manager style of investing is one of the major trends in international markets today. This is logical, given the growing complexity of the economic world and of currency and investment markets which have made it exceptionally difficult for one manager or management group to excel in all areas at all times.”

According to Oldert (2001(b):65), “The difference between FOFs and multi-manager funds is that the FOF manager is buying into independent funds over which he (or she) has no control, whereas the multi-manager fund manager is outsourcing fund management in such a way that he sets investment mandates and ensures the mandates are adhered to.”

6.6 REGULATIONS APPLICABLE TO PRIVATE INDIVIDUALS INVESTING OFFSHORE

Individual South African residents over the age of 18 years who hold a tax clearance certificate may transfer or invest R750 000 offshore. In this text, the aforementioned is referred to as an ‘investment allowance’.

It is important to re-emphasise that the investment allowance only needs to be utilised when using the foreign-based offshore investments, as discussed in section 6.4. When investing in rand-denominated investments (locally domiciled foreign investments) the investment allowance is not utilised.

The regulations that must be adhered to are as follows:

- Completion and delivery of a SARS form called ‘application for tax clearance certificate’.
- Completion, in duplicate, of SARB form called ‘application to purchase foreign currency’.

- Completion of SARB form MP1423.
- Complete investment application.
- Delivery or handing in of all the aforementioned documents.

The application for the clearance certificate is prescribed by SARS. The person wanting to avail themselves of the investment allowance needs to complete and sign an 'application for tax clearance certificate' form. This form is then delivered to a SARS office for approval. If the applicant's tax returns have been submitted and are up to date and no funds are due to SARS, approval should be a formality. It has personally been experienced that SARS has withheld the approval and issuing of the declaration of good standing due to interest of R76 being due to SARS! Once SARS is satisfied with the applicant's tax situation, they approve the application and issue a 'declaration of good standing'.

The SARB requires the 'application to purchase foreign currency application' form to be completed and signed in duplicate. This form requests personal details, tax number, as well as information regarding amounts previously invested offshore. An authorised dealer (usually a bank) handles this form.

According to Kruger, De Kock and Roper (2001:102), "form MP1423 must be completed and signed in duplicate by the applicant if the investment is to be made outside the South African common monetary area. The original must be submitted to the Exchange Control Department of the SARB via the head office of the authorized dealer." This form provides details regarding the investment and the destination of the funds.

Every product would have its own application form on which fund selections are usually made and the transfer of funds are authorised.

At this stage the authorised dealer is usually given all the aforementioned forms plus a certified copy of the applicant's identity document and, of course, a cheque for the investment amount. The authorised dealer then transfers the funds to the product provider offshore and the offshore investment is done.

6.7 SUMMARY

In this chapter a distinction was made between rand-denominated foreign investments and foreign-based offshore investments.

Popular rand-denominated foreign investments and foreign-based investments, as well as the costs and/or fees associated with them, were discussed.

Broad international investment strategies as well as portfolio investment styles were mentioned. Investors need to consider their personal circumstances, objectives and risk tolerance prior to making any decisions regarding the aforementioned.

The investment process was highlighted and the contribution that the correct asset allocation plays in providing risk adjusted returns was briefly discussed.

Lastly, the various investment management styles as well as the regulations applicable to private individuals were reviewed.

CHAPTER 7

CHAPTER 7: OBSTACLES TO INVESTING OFFSHORE

	Page
7.1 INTRODUCTION	149
7.2 HOME BIAS	149
7.3 OVER-EMPHASISING PERFORMANCE	157
7.4 VAST ARRAY OF CHOICES	157
7.5 JURISDICTION AND CURRENCY SELECTION	158
7.6 COSTS	158
7.7 SUMMARY	158

Chapter 7

OBSTACLES TO INVESTING OFFSHORE

7.1 INTRODUCTION

This chapter briefly discusses obstacles that the South African investor should be aware of prior to investing offshore. These obstacles include:

- the home bias phenomenon;
- over-emphasis on performance;
- variety of products and fund managers;
- jurisdiction and currency selection; and
- costs.

7.2 HOME BIAS

According to the Centre for Research in Economics and Finance in Southern Africa (1997:27), home bias refers to the fact that “investors typically exhibit a preference for domestic over foreign investments on the ground of their superior information and understanding of the domestic economy relative to foreign markets (and to foreign investors).”

French and Poterba (as cited in Coval and Moskowitz, 1999) said, “US equity traders allocate nearly 94 percent of their funds to domestic securities, even though the US equity market comprises less than 48 percent of the global equity market.”

Coval and Moskowitz (1999:2045-2073) also state the following:

- The aforementioned phenomenon, called the ‘home town bias puzzle’, exists in other countries as well, where investors appear to invest in their own country, virtually ignoring foreign opportunities.

- The preference for investing close to home also applies to portfolios of domestic stocks. US investment managers exhibit a strong preference for locally headquartered firms.
- “Results suggest that asymmetric information between local and nonlocal investors may drive the preference for geographically proximate investments, and the relationship between investment proximity and firm size and leverage may shed light on several well-documented asset pricing anomalies.”

In a research paper written by Kang and Stulz (1997:3-28), on non-Japanese investors' ownership of Japanese firms between 1975 to 1991, some of their important findings included the following:

- They confirmed the existence of substantial home bias. Their reasoning was that if investors hold the world market portfolio, the weight of Japan in their portfolio should be equal to the weight of Japan in the world market portfolio. They proceeded to plot the weight of Japan in the world market portfolio using data from the Morgan Stanley International world market portfolio. During this period this fluctuated between $\pm 12\%$ (in 1975) to $\pm 42\%$ (between 1987 and 1989), and dropped down to 30% (in 1991). They also plotted the value of the portfolio of Japanese stocks held by foreign investors as a percentage of the value of the world market portfolio. Over this period foreigners always held disproportionately less of the Japanese market portfolio. The percentage held never exceeded $\pm 2\%$.
- They showed that foreign investors were consistently biased against investing in small Japanese firms. Foreign investors preferred investing in large firms in the manufacturing industries with good accounting performance, low unsystematic risk and low leverage.

Table 7.1 indicates the holdings of foreign securities by various countries' pension funds.

Table 7.1 Pension fund holdings of securities issued by non-residents in September 1998

Country	%
Germany	5,0
Japan	9,0
United Kingdom	19,8
United States of America	5,7

Source: IMF, International Capital Markets, September 1998 (as cited in Cooper, 2001).

Table 7.1 clearly indicates that pension funds in Germany and the United States hold almost all their assets in domestic securities. The fact that the aforementioned data represents pension funds and not private international investors is immaterial because most private international investors regard the contributions to pension funds as part of their investment portfolio.

According to Knight (2001:5) (who is Dean and Fellow in Finance at Templeton College, Oxford University), "Although many companies are listed on multiple stock markets, astonishingly few of their shares are held outside their home countries. The much-heralded listing of Daimler-Benz on the New York Stock Exchange, for example, resulted in only around 3 percent US ownership." He goes on to say, "More recently, under the pressure of privatisation a number of other European companies, including Deutsche Telekom and Rhône Poulenc, have sought equity capital abroad. But it remains hard to find an example of a global company where the majority of shares are held outside the home country."

Even although the benefits of international diversification have been well documented, home bias clearly exists. Internationally, investors' portfolios remain highly concentrated in their home markets.

Table 7.2 indicates South Africa's foreign assets over the period 1986 to 1998.

Table 7.2 Foreign assets (South Africa's investment in other countries), 1986-1998

	1986 Rbn	1988 Rbn	1990 Rbn	1992 Rbn	1994 Rbn	1996 Rbn	1998 Rbn
Direct investment	24,08	28,67	38,46	54,33	67,70	114,01	170,00
Non-direct investment ^a	14,20	15,93	16,46	24,54	29,96	50,14	162,90
Total ^b	38,28	44,60	54,92	78,87	97,66	164,15	332,90
Direct investment as a proportion of total	62,9%	64,3%	70,0%	68,9%	69,3%	69,5%	51,1%
Increase (direct investment)	–	19,1%	34,2%	41,2%	24,6%	68,4%	49,1%
Increase (direct investment) 1986-1998	–	–	–	–	–	–	606,1%
All foreign liabilities vs foreign assets	211,0%	180,0%	163,0%	158,0%	189,0%	172,0%	124,0%
Direct foreign liabilities vs foreign assets	91,0%	64,0%	61,0%	60,0%	66,0%	54,0%	54,0%

a Includes portfolio investment, and long and short term loans from various sources.

b Figures should add up vertically but may not, owing to rounding.

Source: South African Reserve Bank (as cited in Forgey, 2001:450).

The information in Table 7.2 (non-direct investment, which includes portfolio investment) needs to be interpreted while considering the relaxation of exchange control information, as presented in Chapter 3.

Part of the reasons for the dramatic increase (67%) in non-direct investment, during the 1994 to 1996 period, was due to the fact that in June 1995, South African international investors (long term insurances, pension funds and unit trusts) were given permission to exchange part of their South African portfolio for foreign securities through approved asset swap transactions. The dramatic increase of 225% in the 1996 to 1998 period could be mainly due to the relaxation of exchange control over South African residents, which commenced in July 1997.

The following information also needs to be considered:

- Steyn (1999): "Individuals have taken an unexpectedly low amount of about R3 billion out of SA since exchange controls on their investments were eased in July 1997. Reasons mooted for the small outflows include South Africa's lack of disposable income, as well as the fact that a huge chunk of capital had already

left the country surreptitiously, so there was not much pent up demand for offshore diversification.”

- Katzenellenbogen (2001(a)): “The Reserve Bank said last February that R9,4 bn had been invested abroad under the mechanism since its 1997 inception. This implies that the annual rate of flight was about R3,4 bn a year until February last year.”
- Katzenellenbogen (2001(a)): “Finance Minister Trevor Manuel told Parliament yesterday that R17,4 bn had left the country between the inception of the investment allowance in July 1997 and the end of last year. The figures – the first since February last year – may explain why government appears to have slowed down the pace of its liberalisation of foreign exchange controls. The shock rise in the use of the offshore investment allowance may be part of the reason why government did not raise the limit from R750 000 to R1 m when the 2001-02 budget was presented to Parliament last month. Manuel said yesterday that 73 814 people had used the investment allowance since its inception.”
- Katzenellenbogen (2001(a)) goes on to state: “The latest outflows are reflected in the strong contraction of the surplus of SA’s financial account, often considered the bottom line of the balance of payments. For last year as a whole, the country’s surplus on the financial account contracted from R29,5 bn in 1999 to R8,5 bn. The surplus is a little above the total outflow through the investment allowance between February and December last year.”
- Katzenellenbogen (2001(b)): “National treasury director-general Maria Ramos said yesterday that the national treasury remained fully committed to the liberalisation of exchange controls and it was not deterred by volatile capital flows. The amount sent out under the allowance since its inception in July 1997 was ‘well within the framework’ and not the reason for the treasury’s decision not to raise the limit, Ramos said.”
- Di Turpin, chairperson of the Association of Unit Trusts (as cited in Lambrechts, 2001), reported early in September 2001 that “offshore unit trusts (foreign collective investment schemes) registered with the Financial Services Board have attracted approximately R57 billion from local investors over the past three years. 302 locally registered offshore funds (in which you invest by using all or

part of your R750 000 foreign investment allowance) have attracted more than a quarter of all money invested through unit trusts sold in South Africa. The assets of offshore funds (foreign collective investment schemes) grew by more than 40% – R16,4 billion – over the year ended 30 June 2001. (This is the first time that the AUT released these figures). Total investment in South Africa's 660 approved funds (358 local and 302 offshore funds) as at the end of June 2001 amounted to nearly R200 billion. Foreign fund assets are now making up more than 40% of inflows into the local industry. These funds should not be confused with rand-denominated foreign funds, which do not require the use of foreign exchange. Two-thirds of these rand-denominated funds have been closed to new investment because of changes to asset-swap regulations in February 2001."

- According to Di Turpin (as cited in Bamber, 2002), at the end of June 2002 (five years after direct foreign investment was first allowed), the value of investment in both rand-denominated and foreign currency unit trusts amounted to R92,7 billion – 38% of the R244 billion total of assets under management in the South African unit trust industry.

The aforementioned South African figures, plus the fact that two-thirds of rand-denominated funds are closed for business, does seem to indicate that South Africans have realised the importance of investing offshore. Dramatic rand depreciation in 2001, the Zimbabwe situation, as well as other specific risk factors, have obviously contributed to the South African investors coming to terms with the importance of offshore diversification.

Could it be that South African investors are less inclined to be dominated by the home bias phenomenon?

Among the main problems perceived with international investing (and thus mainly contributing to the existence of home bias), is currency risk in global portfolios, understanding co-movements among different markets, selecting shares, geographic proximity to an investment, concerns regarding foreign governmental control or interference.

Currency or exchange rate risk as defined by Bodie, Kane and Marcus (2001:645) is “the uncertainty in asset returns due to movements in the exchange rates between the dollar and foreign currencies.” For the South African investor the term ‘dollar’ should be substituted with ‘rand’. The rand return from a foreign investment depends not only on the returns in the foreign currency, but also on the exchange rate between the rand and that currency.

This currency or exchange rate risk (the risk that the return on the investment, when converted back into rands, will be different from expected), due to changes in exchange rates, may be substantial when dealing with a very volatile currency like the rand. During December 2001 the rand-US dollar exchange rate was R13,85. During the middle of January 2003 the rand had strengthened to R8,74.

Although the factors determining changes in exchange rates are complex and, it appears, inadequately understood, two basic relationships ought to hold in a world with international trade. The two relationships are purchasing power parity and the so-called International Fisher effect.

The purchase power parity test (PPPT) mentioned in section 5.2.1.7, is concerned with the relationship between inflation and exchange rates.

As inflation also affects interest rates, Fisher postulates that interest rates fully take account of expected (as opposed to actual) inflation (Rutherford, 1985:306).

Actual and expected inflation and interest rates all impact on exchange rates. Exchange rate risks alter returns on different stock markets and usually reduce the correlation of these returns with the SA market.

Rand volatility has a very substantial impact on offshore investment returns.

Rand performance against all major hard currencies has been dismal and has been discussed in section 5.2.1.7. It is generally accepted that the rand will

continue to depreciate by the inflation-differential between South Africa and its major trading partners.

According to academic Philippe Jorion (as cited in Cooper, 2001), the extra risk from currency fluctuation is small for international equity portfolios. The currency risk could also be hedged at low costs by using the spot and forward foreign exchange markets or by borrowing the expected proceeds in the foreign currency.

Understanding co-movements among different markets refers to the correlations between various world markets, as indicated in Table 5.7. The importance of South African investors (in a mature emerging market) investing in developed or other developed world markets has already been emphasised throughout this text.

The difficulty regarding the selection of shares will depend on numerous factors that would include portfolio management style. Investors should bear in mind that information on shares is not uniformly reliable. There are big variations in accounting standards and disclosure practices in different markets throughout the world. These differences can confuse investors trying to evaluate companies across borders and lead them to make costly mistakes. South African investors would do well to invest in developed markets where reporting standards are good. Using a passive investment style and investing in index funds, WEBS and/or SPDRs eliminates the share selection problem.

Coval and Moskowitz (1999:2070-2071) state that geographic proximity plays an important role in determining an investor's portfolio choice. They go on to say that, "on an international scale, investment proximity may account for a large portion of the observed abstinence in holdings of foreign securities." Present research indicates that investors are more likely to invest in companies that are well known to them and in their close proximity.

Geographical proximity could also be influenced by the endowment effect, a phenomenon identified by behavioural finance, where investors set a higher value on something they already own than they would be prepared to pay to acquire it.

Investments in well-known local companies in close proximity – companies that both investors and financial intermediaries know and can identify with – are more likely to attract investment than their geographically unknown counterparts. Uncertainty regarding transaction costs also ostensibly compound the problem.

Concerns regarding national governmental controls relate to punitive taxes and fears that exchange control regulations may be instituted, preventing the repatriation of the offshore investors' capital. These are very realistic concerns that need to be addressed prior to deciding which offshore investment destination to use. South Africans investing offshore should invest in stable developed countries where these concerns are minimised.

7.3 OVER-EMPHASISING PERFORMANCE

The primary objective of a South African offshore investor should be risk reduction via diversification of their portfolio and obtaining exposure to developed world markets in hard currencies. Offshore investments are more stable over the long term. Over-emphasising short term investment performance should be avoided.

7.4 VAST ARRAY OF CHOICES

Only very experienced investors should use non-FSB approved products. These investors usually need to do a lot more homework and make use of a good translator when dealing with companies in Switzerland, France and Germany is essential.

As already stated, FSB approved products and companies adhere to certain minimum requirements prior to registration with the FSB. If a company carries FSB approval, the investor will have recourse, through the regulatory body in the company's home country, should something go wrong.

7.5 JURISDICTION AND CURRENCY SELECTION

When considering in which country and currency to invest, the following should be considered:

- political and economic stability;
- how income and capital is taxed;
- how active and legitimate are the banking, professional and corporate services sectors;
- language of communication, transport and how accessible is the country; and
- time variances.

Careful consideration should be given regarding in which currency the investment will be denominated. Preference should be given to hard currencies (e.g. USD, pounds and euros).

7.6 COSTS

Not all offshore product providers are transparent regarding the costs of their investments or investment products. Hidden costs such as, for example, early withdrawal costs or penalty, valuation or switching fees (fees for switching from one portfolio to another) could be expensive in the offshore environment. All these costs should be determined and understood. Chapter 6 discussed the costs of various offshore investments.

7.7 SUMMARY

Various obstacles to investing offshore were mentioned. The home bias phenomenon as well as possible reasons for the existence of this phenomenon were discussed. Other obstacles that included over-emphasising performance, the use of FSB approved products, jurisdiction, currency selection as well as costs, were briefly identified.

CHAPTER 8

CHAPTER 8: TAX IMPLICATIONS OF OFFSHORE INVESTMENTS

	Page
8.1 INTRODUCTION	159
8.2 INCOME TAX	159
8.2.1 Taxation of residents on their worldwide income	159
8.2.2 Rand-denominated products	163
8.2.3 Foreign-based offshore investments	164
8.2.4 Capital Gains Tax	166
8.3 ESTATE DUTY	167
8.4 SUMMARY	168

Chapter 8

TAX IMPLICATIONS OF OFFSHORE INVESTMENTS

8.1 INTRODUCTION

This chapter briefly identifies the Income Tax (CGT included) and Estate Duty implications of a South African resident (natural person) investing offshore.

8.2 INCOME TAX

8.2.1 Taxation of residents on their worldwide income

Prior to 1 January 2001, South Africans were taxed on a source basis. This meant that South African residents were only taxed on income earned from a South African source (or deemed source) and, generally speaking, income earned from foreign sources were not taxable in South Africa.

With effect from 1 January 2001, South Africans are taxed, on a residence basis, on worldwide income. This change of system applies to years of assessment commencing on or after 1 January 2001.

Section 9C of the Income Tax Act No. 58 of 1962 (as amended) (ITA), which sought to tax so-called passive income in the form of interest, rentals, annuities and royalties, has been repealed since all forms of foreign income (active and passive) are now taxable. Foreign dividends, unlike local dividends, are also taxable.

The residence or, more correctly, 'residence minus' system has the effect that South African resident taxpayers are taxed on their worldwide income, although

certain categories of income and activities undertaken outside South Africa are exempt from South African tax.

Because of the aforementioned amendments to the ITA, it is important to distinguish between South African residents and non-residents.

Section 1 of the ITA defines a resident. In the event of an individual (natural person) being defined as a South African resident, then he or she will be taxed on their worldwide income in South Africa.

The aforementioned section 1 definition includes two alternative tests to determine whether a natural person is resident in South Africa. The first test determines residence on the basis of a person being ordinarily resident in South Africa. The second test requires a person to be physically present in South Africa for a certain period to be regarded as a South African resident (Kruger, De Kock and Roper (2001:12). Both the aforementioned tests will briefly be discussed.

- Ordinary residence test

According to Kruger, De Kock and Roper (2001:12), "If a person is ordinarily resident in South Africa he or she is automatically a South African resident. The term 'ordinarily resident' is not defined in the ITA. The courts have interpreted 'ordinarily resident' to mean the place where a person has his or her place of permanent residence. If a person is outside South Africa and has the intention to return to South Africa, such person will, based on the 'ordinary residence test', be regarded as being resident regardless of the period of time spent outside South Africa.

A person will therefore become a resident and be taxed on his or her worldwide income by virtue of him or her being ordinarily resident, from the date that such person becomes so ordinarily resident, until he or she ceases to be ordinarily resident in South Africa."

- Physical presence test

According to Kruger et al. (2001:12), there are two physical presence tests to determine South African residence:

- the presence in South Africa test; and
- the presence outside South Africa test.

- The presence in South Africa test

According to the same source, "This test determines that a natural person who was not at any stage ordinarily resident in South Africa during a year of assessment will be deemed to be a South African resident if he or she is physically present in South Africa for more than 91 days (or part days) during the year of assessment and:

- was physically present in South Africa for more than 91 days (or part days) in aggregate in each of such three preceding years; and
- was physically present in South Africa for more than 549 days (or part days) in aggregate during the three years preceding the particular year of assessment."

Of importance is the fact that it is not necessary to be present in South Africa on a continuous daily basis or for full days, in order to be regarded as a South African resident.

- The presence outside South Africa test

According to Kruger et al. (2001:14), "Where a person who is regarded as resident in terms of the above test remains outside South Africa for a continuous period of at least 330 full days, immediately after the day that he or she leaves the country, such person shall be deemed not to have been a resident from the day that he or she left South Africa."

Kruger et al. (2001:14) go on to say, "Contrary to the presence in South Africa, this test requires a person to be present outside South Africa for 330 continuous full days. This presents a stricter presence requirement and the

330 day period will be interrupted if a person is present in South Africa for any part of a day during this period. It is important to emphasise that the physical presence test will not apply in respect of any person who was at any stage during the year of assessment ordinarily resident in the Republic. This will avoid the possibility that a person who was ordinarily resident in South Africa and who has emigrated, could still in terms of the day-rule be regarded as being a resident and be taxed on his or her worldwide income for the full tax year.”

Section 9D of the ITA was introduced to discourage South African residents from using foreign entities to avoid foreign income accruing to the South African resident. This section defines controlled foreign entity, foreign entity and participation rights. Although this is important, because this section discusses taxpayers other than natural persons, it will not be discussed in detail. Suffice to say that where a South African resident individual or company has a controlling interest in a foreign company, the income of such foreign company is imputed to the South African resident in terms of this section (Kruger et al., 2001:17).

In terms of section 9E, a South African resident who has an interest in a foreign company, either directly (as a shareholder) or indirectly (for example, as a unit holder in a unit trust), may be taxed on dividends received from such a company.

According to Kruger et al. (2001:36), “Section 9F has the effect that income will not be included in the taxable income of a South African resident if it is not possible to remit such income to South Africa as a result of a restriction, e.g. exchange control, in the foreign country.”

Residents earning offshore income and/or with offshore company or trust structures current tax positions could be greatly affected by the aforementioned sections 9D, 9E and 9F of the ITA.

The manner in which certain specific types of offshore investments are taxed will now be briefly discussed.

8.2.2 Rand-denominated products

Generally, a South African resident receiving dividends from rand hedge equities listed on the JSE, will be exempt from income tax in terms of section 10(1)(K) of the ITA.

According to Kruger et al. (2001:34), "Policyholders who invest in rand denominated endowment policies with offshore exposure via asset swaps, will not be taxed in their personal capacity. The foreign dividends will be taxed in the hands of the life office company in the appropriate policyholder's fund. The rate for the individual policyholder's fund is currently 30%."

Foreign dividends and interest earned in rand-denominated unit trust portfolios will be taxed in the unit holder's hands at his or her marginal tax rate.

The taxation of tranches would depend on how the tranche has been structured. According to Kruger et al. (2001:34), "where there are offshore share or fund holdings, the foreign dividends would be taxed locally in the hands of either the investment company or individual investor, depending on how the investment is structured."

Certain income is exempt from tax in terms of the provisions of section 10. According to Huxham and Haupt (2002:50), section 10(1)(i) exempts certain dividends and interest. The aforementioned section says that "in the case of any taxpayer who is a natural person so much of the aggregate of any dividends and interest received or accrued to him which are not otherwise exempt from tax as does not exceed:

- in the case of a person who has attained the age of 65, the amount of R5 000; or
- in any other case, R4 000.

Provided that the exemption first applies to foreign dividends (as contemplated in section 9E) and thereafter to interest and other dividends."

8.2.3 Foreign-based offshore investments

These are offshore investments made by a South African resident using their R750 000 investment allowance.

Foreign dividends earned on shares are taxed in terms of section 9E. This section has its own currency conversion rules. According to Huxham and Haupt (2002:276), "the income of the company may be subject to tax in the resident shareholders' hands in terms of section 9D if it is a controlled foreign entity in which case the dividend will be exempt from the provisions of section 9E."

According to Kruger et al. (2001:35), "Where less than 10% of shares are held in a company the dividend declared will be taxed in the hands of the shareholder. Where 10% or more shares in a company are held the shareholder may elect whether the proportionate profit from which the dividends are declared or the dividend itself should be included in his taxable income. Where the gross dividend or foreign profits are included in the taxable income of the shareholder, credits will be allowed in respect of any foreign taxes paid. In certain instances these dividends may be exempt from tax if the necessary requirements are met."

Section 9E(8) deals with designated countries. Foreign dividends received from designated countries are exempt from tax. According to Huxham and Haupt (2002:294), "the Minister may designate countries which

- have entered into a double tax agreement with the Republic;
- have a tax on income that is determined on a basis which is substantially the same as the Republic;
- have a statutory rate of tax on companies of at least 27%;
- comply with any other requirement which the Minister may prescribe."

According to the same source, "interest which accrues to a resident is subject to tax in South Africa. The foreign currency amount is converted into South African rands at the ruling exchange rate at the time of accrual, in terms of section 25D."

The interest is subject to the R4 000 (R5 000 if older than 65) exemption, already discussed.

Certain foreign insurers offer policies to South African residents. According to Hartmann et al. (2001:B52), "these are not policies of insurance as contemplated in the Long-term Insurance Act, and the South African Revenue Service has no jurisdiction over these insurers or the managers of the underlying fund. There are therefore no income tax implications during the term of these policies."

Capital Gains Tax will, however, be payable on the capital gain, unlike the case for policy contemplated in the South Africa Long-term Insurance Act.

The definition of 'company' in section 1 of the ITA includes unit trusts. According to Huxham and Haupt (2002:276), "the income from such an investment is taxed as it would be as if the unit trust was South African."

The income from property, bank accounts (subject to certain wear and tear allowances) and foreign currency bank accounts is subject to tax in South Africa.

The tax situation of hedge funds, options and warrants would depend on in which structure they are invested.

Despite all the aforementioned amendments, policing the taxation of offshore investments remains difficult. Due to the aforementioned problem, the Commissioner has introduced proposed amendments to section 78 of the Income Tax Act. According to Wiseman (2002:8), "In order for the Commission to invoke the new provisions, he must have reason to believe that residents have not, in their tax returns, declared or accounted for:

- any funds held in foreign currency or any assets owned outside the Republic; or
- any funds held in foreign currency or any assets from which any income or gain would be attributable to the resident during a year of assessment. In order to determine the taxable income derived from the assets or funds estimated in

terms of this section, the Commissioner must apply the official rate to the funds.” The official rate of interest to be used is currently 13% per annum.

The rationale for these amendments is clearly to enforce tax compliance. Due to residence-based tax, all income earned should be declared in taxpayers’ tax returns.

8.2.4 Capital Gains Tax

Capital Gains Tax (CGT) was introduced into the ITA by means of Act No. 5 of 2001. In terms of paragraph 2 of the 8th Schedule (this schedule of the ITA deals with Capital Gains Tax), Capital Gains Tax provisions apply to disposal of assets on or after 1 October 2001. CGT thus applies with effect from 1 October 2001.

CGT is somewhat of a misnomer. It is actually normal income tax on the taxable portion of a capital gain and not a separate tax.

According to Huxham and Haupt (2002:580), “Briefly, individuals, ‘special’ trusts and deceased and insolvent estates will pay normal income tax on 25% of the capital gains (i.e. capital profits) they make, whereas companies, close corporations, and ordinary trusts will pay normal income tax on 50% of the capital profits that they make. Special rules apply to long-term insurance companies.”

All South Africa residents are liable for CGT. The residence rules, as briefly discussed in section 8.2.1, are thus also applicable.

All capital gains (inclusive of currency depreciation) on the rand-denominated and foreign-based offshore investments (discussed in sections 6.3 and 6.4) will be subject to CGT.

Certain CGT annual exclusions are available to resident natural persons. The first R10 000 of a natural person’s capital gains are excluded in each year of

assessment. When a person dies during a year of assessment, such a person's annual exclusion for that year of assessment is R50 000.

According to Kruger et al. (2001:43), "Section 6 quat of the ITA prevents double taxation in respect of the disposal of assets situated outside South Africa. In terms of international norms the country where the asset is situated (source country) has the primary (strongest) right to tax in respect of gains from the disposal of units. If gains from the disposal of assets situated in a foreign country is taxed in such foreign country, a credit will be granted against South African tax in respect of foreign taxes levied on these gains."

8.3 ESTATE DUTY

Estate duty is levied in terms of the Estate Duty Act 45 of 1955 on the estates of deceased persons resident in the Republic at the time of death, no matter where it is situated.

Section 3 of this Act defines property and deemed property. These sections include all property (no matter where situated) belonging to a South African resident at time of death.

Estate duty is calculated on the 'dutable amount' of the estate. In respect of persons who died on or after 1 October 2001 (the date of the implementation of CGT), the rate of estate has been reduced from 25% to 20%.

An abatement of R1 000 000 applies to the estate of any person dying on or after 16 March 1988 (Miller, A195). Generally speaking, the estate of any person dying after 16 March 1988 is subject to an abatement of R1 000 000 (R1 000 000 is subtracted from the nett value of the estate) and the remainder is subject to estate duty at 20%.

Rand-denominated and foreign-based offshore investments, owned by South African residents, are thus property as defined in the Estate Duty Act.

8.4 SUMMARY

The major income tax (inclusive of CGT) implications of investing offshore have to be highlighted. Generally speaking, dividends received from offshore companies, unlike local dividends, are taxable. Dividends received from companies in designated offshore countries (section 9E of the ITA) are exempt from taxation.

Subject to residence rules all foreign interest (excluding S10(1)(i) exemptions) are taxable in South Africa.

Capital profits realised on the sale of offshore assets are subject to CGT. South African residents also pay Estate Duty on assets situated anywhere in the world.

Tax legislation is dynamic and is constantly being amended. Investors should ensure that they are aware of the tax implications of any investment made.

CHAPTER 9

CHAPTER 9: CONCLUSIONS AND RECOMMENDATIONS

	Page
9.1 INTRODUCTION	169
9.2 CONCLUSIONS	169
9.3 RECOMMENDATIONS	172

Chapter 9

CONCLUSIONS AND RECOMMENDATIONS

9.1 INTRODUCTION

The conclusions and recommendations hereafter discussed include the most important facts concerning offshore investments from a South African resident's perspective.

The offshore investment industry is dynamic. The findings must thus in future be evaluated accordingly.

9.2 CONCLUSIONS

9.2.1 As a result of the implementation of recommendations made in the final De Kock Commission's Report (1985), a South African resident (as from 1 July 1997), subject to certain criteria, is allowed to invest offshore. An amount of R750 000 may currently be invested offshore.

9.2.2 Slow economic growth, rand depreciation, as well as the amount of funds already transferred offshore (R92,7 billion via rand-denominated and foreign-based offshore unit trusts), may have combined to place a hopefully temporary halt to the Government's declared policy of a gradual continual easing of foreign exchange controls.

9.2.3 Residents should adhere to certain financial prerequisites – these include those listed below – prior to investing offshore:

- adequate life insurance;
- should have equity in a house;
- should have modest consumer debt;

- should have emergency funds;
- should have enough money to invest to make the offshore investment profitable and economical.

9.2.4 The crux of modern portfolio investment theory is that, through efficient diversification the overall risk of an investment portfolio can be reduced, as combinations of investments with different cyclical characteristics smooth the volatility of returns of the portfolio. The essential concept of portfolio theory is that the risk of a security as a component of a portfolio is very different from its risk in isolation.

9.2.5 The primary objective for investing offshore is to obtain the benefits of diversification (spreading of risk).

9.2.6 Due to mainly the following factors, diversifiable (specific or unsystematic) risk can be reduced by international diversification:

- lack of international competitiveness;
- corruption, crime and corporate governance;
- productivity and skills shortage;
- AIDS/HIV virus;
- country or political risk;
- low economic growth;
- exchange rate risk.

The aforementioned factors/problems are unique to South Africa. Accordingly, South African investors should minimise these risks by investing part of their portfolios offshore. Investors are not compensated for bearing this country and business specific risk.

9.2.7 Numerous empirical evidence, discussed in section 5.2.1.8, indicates that by diversifying offshore, average portfolio risk is reduced and returns enhanced.

- 9.2.8** International and South African empirical evidence (sections 5.2.2.2 and 5.2.2.3) suggest that, although market risk cannot be eliminated, it can be reduced by offshore diversification.
- 9.2.9** Astute investors should avail themselves of the offshore diversification benefits. South Africans should ideally invest in developed and/or other developed markets with a low or negative correlation to South Africa's mature emerging market. The importance of asset allocation, as indicated in this assignment, should not be underestimated.
- 9.2.10** Various rand-denominated and foreign-based offshore investments discussed indicate the tremendous variety and diversity of offshore products and costs/fees. The cumulative break-even returns (sections 6.3.5 and 6.4.11) clearly indicate the substantial impact costs have on investment returns.
- 9.2.11** The most important obstacles to investing offshore include:
- home bias phenomenon;
 - currency or exchange rate risk;
 - over-emphasising performance;
 - vast array of choices;
 - jurisdiction and currency selection;
 - costs.

The aforementioned obstacles appear fairly insignificant, especially after considering the risk reduction advantages achievable by offshore diversification. The impact of the currency on exchange rate risk, as amplified by the recent strengthening of the rand against the US dollar (currently, 16 January 2003, trading at R8,74), compared to the rand/dollar exchange rate of R13,85 at the end of December 2001. The rand, which had suffered as a result of a speculative attack, has clawed back most of the losses it suffered at the end of 2001.

Timing any market is impossible. The currently strong exchange rates provide a tremendous opportunity to diversify offshore.

Mainly due to the inflation differential between South Africa and its major trading partners, and because our commodity-based economy could experience difficulty in a slow global economic growth environment, economists expect the rand to depreciate when South Africa's relatively high interest and inflation rates commence decreasing.

- 9.2.12** With effect from 1 January 2001, South Africans are taxed on worldwide income. Foreign dividends, unlike dividends earned from South African companies, are subject to tax. It is important to disclose all offshore income earned in local tax returns.

9.3 RECOMMENDATIONS

- 9.3.1** The offshore investment industry is large, well controlled and regulated. All South African investors should make use of this tremendous investment opportunity. The main advantages of offshore investing are the risk reduction and enhanced portfolio performance benefits obtained by diversifying into other countries, other markets, other industries and other companies. No astute investor would put all their investment eggs in one basket, especially considering the risk and size of the South African basket. With global diversification, one never bets one's entire investment portfolio (nest egg) on the economic or political stability of any one country. Astute investors diversify by investing offshore.
- 9.3.2** It appears that the offshore investment industry is favourably viewed by clients and financial intermediaries, in terms of service, investment management and products provided. Accordingly, use should be made thereof.

- 9.3.3** The disclosure or transparency of costs and/or fees, especially among non-approved Financial Services Board (FSB) providers is unsatisfactory. FSB approved providers are compelled to disclose all costs and fees.

Mainly for the following reasons it is recommended that FSB approved products are used:

- all costs are transparent and must be disclosed; and
- approved providers must have a local presence (offices, staff, independent trustees or custodians) in South Africa.

In the event of investing in non-approved FSB products, investors should perform a thorough due diligence.

- 9.3.4** The last increase in the amount that South African residents were allowed to invest offshore (R750 000) was announced on 23 February 2000. It appears as if the Government has placed a temporary halt on their declared policy of the gradual easing of exchange controls.

South Africa is a debtor nation. The Government could at any time (though unlikely) change their exchange control policy and accordingly prevent capital flight.

Due to the aforementioned reason, the R750 000 investment allowance route should be the preferred method of investing offshore. After the required clearances have been obtained, the funds can be invested offshore. Very importantly, these funds do not need to be repatriated. In contrast, all rand-denominated investments must be repatriated.

- 9.3.5** The decline and fluctuation of the rand exchange rate is alarming. The challenge is to invest in developed countries' currencies that are more likely to be stable and will strengthen against the rand. These currencies should include the US dollar, the euro, Swiss francs and pound.

9.3.6 Before recommending specific offshore investments, some of the factors that need to be contemplated include:

- Investor's personal circumstances (age, dependants, existing asset allocation, nett asset value, personal preferences and investment expertise/acumen, etc.).
- Attitude towards risk and risk profile should be determined.
- Macro situation that would include collapsing equity markets, global terrorism, Zimbabwe's collapse, South Africa's rampant and escalating interest rates, currency confusion and a possible war in Iraq.
- Importance of asset allocation (fundamental to investment performance), the use of various investment strategies and fund managers.
- Other factors mentioned in this assignment.

9.3.7 Specific offshore investment recommendations would include:

- Exposure to an enhanced passive offshore portfolio as advocated by Professor Bradfield in section 6.5.2.2. The aforementioned is achieved by placing the core of the offshore portfolio in a passively managed fund. The following investment vehicles may be used to gain access to an index fund:
 - mutual funds;
 - Standard and Poor's Depository Receipts (SPDR or spider); and
 - WEBS.

A personal preference would be Global Balanced Index funds, Global Bond Index funds and Global Money Market funds.

Exposure could also be achieved via mutual funds that enable investors to match the performance of a specific index, e.g. the Wilshire 5000 Index, the S&P 500, the FTSE and/or the DAX.

The balance of the portfolio should consist of actively managed satellite portfolios to spice performance. Actively managed mutual funds, WEBS and/or directly owned equities or bonds can be used in the satellite portfolios.

- 9.3.8** South Africans should ideally invest in developed and/or other developed markets with a low or negative correlation to South Africa's mature emerging market.
- 9.3.9** South African residents wanting to invest smaller monthly amounts should invest in rand-denominated passively managed offshore equity and/or bond funds.
- 9.3.10** Rand hedge equities as well as tank containers remain attractive investment vehicles due to the tax and retirement planning benefits associated with them.
- 9.3.11** Consider and determine all costs prior to investing as they have a major influence on investment returns.
- 9.3.12** Determine the tax implications of the investment.

REFERENCES

REFERENCES

- Amling, F. 1984. *Investments. An Introduction to analysis and management*, Fifth edition, Prentice-Hall Inc., Englewood Cliffs, New Jersey.
- Amling, F. and Droms, W.G. 1982. *Personal financial management*, Richard D. Irwin, Inc., Georgetown, Ontario.
- Abt Associates Inc. 2001. *Impending catastrophe revisited. An update on the HIV/AIDS epidemic in South Africa*, report commissioned by the Henry J. Kaiser Family and published by LoveLife.
- Barr, G.D.I. 'International diversification after 1985 – the argument becomes stronger', *South African Journal of Business Management*, March 1986, Volume 17, pp. 139-142.
- Basson, D. 'Where the big money will go', *Finance Week*, 23-27 September 2002(a).
- Basson, D. 'Size matters', *Finance Week*, 14-18 October 2002(b).
- Bamber, D.W. *Investing abroad*, Spring 2002, p. 4.
- Barr, G.D.I. and Affleck-Graves, J.F. 'Diversification in foreign assets – a comment', *Studies in Economics and Econometrics*, 1987, Volume 11, No. 2, pp. 94-112.
- Bhana, N. 'The recommendations of the De Kock Commission of Inquiry and its implications for foreign security investments by South African residents', *South African Journal of Business Management*, 1985, Volume 16, pp. 204-208.
- Bhana, N. 'International share portfolio diversification: Possible benefits for South African investors', *South African Journal of Business Management*, 1986, Volume 17, pp. 162-168.

- Bhana, N. 'The use of ex post inter-country correlation coefficients to predict gains from international portfolio diversification from the standpoint of a South African investor', *Investment Analysts Journal*, Summer 1989/90, pp. 7-11.
- Bhana, N. and Konar, L. 'Are our portfolio managers ready to invest overseas when exchange control goes?', *Investment Analysts Journal*, Summer 1992/93, pp. 22-26.
- Bodie, Z.V.I., Kane, A. and Marcus, A.J. 1999. *Investments*, Fourth edition, McGraw Hill Irwin, Singapore.
- Bodie, Z.V.I., Kane, A. and Marcus, A.J. 2001. *Essentials of investments*, Fourth edition, McGraw Hill Irwin, Singapore.
- Bradfield, D. 'Managing risks in a modern unit trust market', *Saturday Argus Personal Finance*, 17 March 2001.
- Bradley, A., Higgins, E. and Abey, A. 2000. *Fortune strategy, the defensive guide*, Investor Education, Mauritius.
- Bullard, D. 'The rand is exactly where it ought to be', *Sunday Times*, 9 September 2001.
- Business Day* Survey. 'Declaring war on HIV/AIDS', *Business Day*, 22 June 2001.
- Business Day* Staff. 'The million-dollar question: Who's killing the rand?', *Business Day*, 26 August 2001.
- Centre for Research into Economics and Finance in Southern Africa. *South African exchange control reform: An update*, July 1997, pp. 26-28.
- Cooper, I. 'An open and shut case for portfolio diversification', *Business Day* supplement – Mastering Investment, 6 November 2001, pp. 5-6.
- Coval, J.D. and Moskowitz, T.J. 'Home bias at home: Local equity preference in domestic portfolios', *The Journal of Finance*, 1999, Volume 54, No. 6, pp. 2045-2073.

- De Kock Commission. 1978. *The Commission of Inquiry into the monetary system and monetary policy in South Africa: Exchange rates in South Africa*, Interim Report, RP112/1978, Government Printer, Pretoria.
- De Kock Commission. 1985. *The Commission of Inquiry into the monetary system and monetary policy in South Africa*, Final Report, RP70/1984, Government Printer, Pretoria.
- De Villiers, J.U. and Favis, R. 'Sector diversification and second order risk', *Studies in Economics and Econometrics*, 1999, Volume 23, No. 2, pp. 77-87.
- Dobbins, R., Witt, S. and Fielding, J. 1994. *Portfolio theory and investment management*, Second edition, Blackwell, Oxford.
- Draper, D.W. and Findlay, M.C. 'Capital asset pricing and real estate valuation', *Areura Journal*, 1982, Volume 10, 153-183.
- Du Plessis, P.G. 1992. *Die beleggingsbesluit*, Derde uitgawe, J.L. van Schaik, Pretoria.
- Du Toit, J. 1998. *The structure of the South African economy*, Second edition, Southern Book Publishers (Pty) Ltd, ABSA Bank.
- Du Toit, J. 2000. *Southern African development community – an economic profile*, First edition, The SA Financial Sector Forum, ABSA Bank.
- Eiteman, D.K. and Stonehill, A.I. 1986. *Multinational business finance*, Fourth edition, Addison-Wesley, Readings, Massachusetts.
- Ellis, C.D. 1983. 'Conceptualising portfolio management', in *Managing investment portfolios – a dynamic process*, J.L. Magin and D.L. Tuttle (Ed.), Warren Graham and Lamont Inc., Boston, Massachusetts.
- Floquet, W. *Investment comparisons*, February 2000, Fleming Martin Research, South Africa.
- Forgey, H., Dimant, T., Corrigan, T., Mophuthing, T., Spratt, J., Pienaar, D. and Peter, N. 2001. *South Africa Survey 2000/01*, South African Institute of Race Relations, Johannesburg.

- Gitman, L.J. 1985. *Principles of managerial finance*, Wright State University, Harper and Row.
- Goodall, B.B. 'Investment planning', *Service*, Issue 4, June 2001, Butterworths, Durban.
- Goodall, B.B. and King, R. 2002. 'The Momentum', *Tax and Investments Easiguide 2002/2003*, Butterworths, Durban.
- Graham, B. 1973. *The intelligent investor*, Fourth revised edition, Harper Business, New York.
- Grant, R.J. 1992. *Exchange control must go*, Free Market Foundation publication.
- Greer, G.E. and Farrell, M.D. 1984. *Investment analysis for real estate decisions*, Dryden Press, New York.
- Hartmann, E., Veldtman, L., Hoffmann, H, Stofberg, T. Schoeman P. and Dawson, J. *Premiums and problems*, Special Examination Edition No. 85, June 2001, Old Mutual Personal Financial Advice Human Resources (Legal), Cape Town.
- Hazelhurst, E. 'Country risk. Argentina's debt problems show up South Africa's financial merits', *Financial Mail*, 26 October 2001.
- Hendriksen, E.S. and Van Breda, J.F. 1992. *Accounting theory*, Fifth edition, Irwin, Homewood, Boston.
- Horwood, O.P.F. 1983a. 'Statement on the abolition of exchange control over non-residents', *South African Reserve Bank Quarterly Bulletin*, (147), March 1983, pp. 25-27.
- Horwood, O.P.F. 1983b. 'Statement with regard to the further development of the foreign exchange market in South Africa', *South African Reserve Bank Quarterly Bulletin*, (149), September 1983, pp. 21-22.
- Huxham, K. and Haupt, P. 2002. *Notes on South African Income Tax*, Twenty-first edition, H&H Publications, Roggebaai.

- Kang, J. and Stulz, R.M. 'Why is there home bias? An analysis of foreign portfolio equity ownership in Japan', *Journal of Financial Economics*, 1997, Vol. 46, pp. 3-28.
- Kantor, B. 'Rand eloquence', *Financial Mail*, 4 May 2001.
- Katzenellenbogen, J. 'Capital flight from SA picks up speed', *Business Day*, 30 March 2001(a).
- Katzenellenbogen, J. 'Ramos not deterred by capital outflow', *Business Day*, 2 April 2001(b).
- Knight, R.F. 'Global finance – the great equaliser', *Business Day* supplement – Mastering Investment, 23 October 2001, p. 2.
- Kreitler, R.P. 2000. *Getting started in global investing*, John Wiley and Sons, Inc., Canada.
- Kruger, N., De Kock, A. and Roper, P. 2001. *The practical guide to offshore investments 2001-2002*, Second edition, The Offshore Investment Corporation, Sunnyside.
- Lambrechts, H. *Unit Trust Survey*, 30 September 2001, No. 51, p. 2.
- Laubscher, E. 'The benefits of diversification for the management of investment portfolios', *The Accountant*, Official Journal of the Commercial and Financial Accountants of Southern Africa, April 2001, pp. 7-8.
- Lynch, P. with Rothchild, J. 1989. *One up on Wall Street*, Penguin Books, England.
- Mail and Guardian*. 'Rand on a slippery slope', 26 April to 3 May 2001.
- Makgoba, M.W. 'AIDS changes the pattern of death', *Financial Mail*, 26 October 2001.
- Maltimulane, B. and Legodi, T. 'SA far behind in global competitiveness, says expert', *Sunday Times*, 12 March 2001.
- Marx, J., De Swart, C. and Nortjé, A. 1999. *Financial management in Southern Africa*, Pearson Education, South Africa.

Meyer, W. 'Lessons from the master investors', *Weekend Argus*, 22 December 2001.

Miller, R.J., updated by Botha, M. 2002. *Corporate and Personal financial planning 2002*, Butterworths, Durban.

Mnyanda, L. 'Rand slumps to new low as volatility continues', *Business Day*, 6 November 2001.

Mohr, P. 2000. *Economic indicators*, Unisa Press, Pretoria.

Oldert, N. January 2001(a). *Offshore unit trusts*, Profile Media, Johannesburg.

Oldert, N. July 2001(b). *Understanding unit trusts*, Profile Media, Johannesburg.

Oldert, N. January 2002(a). *Offshore unit trusts*, Profile Media, Johannesburg.

Oldert, N. September 2002(b). *Unit trusts handbook*, Profile Media, Johannesburg.

Oldert, N. September 2002(c). *Unit trusts handbook*, Profile Media, Johannesburg.

Preece, H. 'SA in sterile GDP trap', *Finance Week*, 7 September 2001.

Preece, H. 'Currency of terror', *Finance Week*, 5 October 2001.

Reilly, F.K. and Brown, K.C. 1997. *Investment analysis and portfolio management*, Fifth edition, Harcourt Brace and Company, USA.

Reilly, F.K. and Brown, K.C. 2000. *Investment analysis and portfolio management*, Sixth edition, Dryden Press, United States of America.

Rosenberg, J.B. 'The maintenance of living standards hypothesis – the key to practical selection of efficient portfolios', *Investment Analysts Journal*, Spring 1991, pp. 21-29.

Ross, S.A. 'The arbitrage theory of capital asset pricing', *Journal of Economic Theory*, December 1976.

- Ross, S.A., Westerfield, R.W., Jordan, B.D. and Firer, C. 1999. *Fundamentals of corporate finance*, The Irwin McGraw-Hill Companies, Inc., Australia.
- Rutherford, J. *Introduction to stock exchange investing*, 1985, MacMillan Publishers Ltd, London.
- Solnik, B. and Noetzlin, B. 'Optimal international asset allocation', *Journal of Portfolio Management*, 1982, Volume 9.
- Steyn, G. 'SA's outflow a mere trickle', *Business Day*, 29 January 1999.
- Swart, N. 1996. *Personal financial management*, Juta and Co. Ltd, Cape Town.
- Swart, N. 1999. *Investing your package: All you need to know*, Unisa, Pretoria.
- Temkin, S. 'Act paves way for hedge funds to be sold directly in SA', *Business Day*, 7 December 2002, p. 2.
- Thomas, S. 'Direct share investment cut costs', *Financial Mail*, 3 May 1992, pp. 85-86.
- Van den Honert, R. and Affleck-Graves, J.F. 'International diversification and the South African investor', *South African Journal of Business Management*, 1985, Volume 16, pp. 87-91.
- Van der Berg, B. 1998. *Derivatives and financial instruments*, Kagiso Publishers, Pretoria.
- Van der Merwe, S. 'SA earns few plaudits in crooked index', *Business Day*, 28 June 2001.
- Van Niekerk, T. *Extra Cover*, April/May 2001.
- Weil, D. 'Active vs passive management', *Sunday Times Business Times*, 1 July 2001.
- Wiseman, J. *Extra Cover*, August/September 2002, pp. 8-9.